

# INFLATIONARY PRICE TRENDS IN INDIA SINCE 1939

by

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TO  
MY FATHER AND MOTHER



## PREFACE

THE EXIGENCIES of the last World War and the means adopted by the Government of India to finance it ushered in a period of high prices which has continued up till now. The return of peace in 1945 did not bring about any recession. On the other hand, since 1945, although at times prices declined to some extent, yet on the whole the uptrend in prices continued, assuming at times an inflationary aspect. This was fostered by certain external factors as well as by an important domestic factor, namely, the incurring of large outlays by the Central and State Governments on account of various development programmes. The latest phase in the upward movement of prices occurring at the close of the First Five Year Plan has brought into relief the inflationary danger involved in large investment outlays and has helped to focus attention on the problem of finding out means of promoting economic development with stability. But any policy designed with a view to attaining this end should be based on an understanding of the fundamental factors affecting price level in the country. In this book I have made an attempt to analyse the general pattern of price trends in the country since 1939 and to examine how far such factors as war finance, developmental outlays, balance of payments position and production trends in the country influenced prices and how the rapid rise in prices affected the consumption habits and standards of life of the people. The concluding chapter deals with the steps taken by the government to keep prices under control and the emergence in recent years of what may be called a price policy.

In preparing this book I have received help from many. To Dr. R. Balakrishna, Professor of Economics of the Madras University, I want to express my respectful gratitude for the continued interest he has shown in my work. I should also like to acknowledge my indebtedness to Mr. C. W. B. Zacharias, Deputy Director, Agricultural Economics Research Centre, Madras University, and Mr. K. S. Sonachalam, Deputy Director, Economic Survey of Madras, Madras University, for some valuable suggestions. I also profited immensely by discussions with Professor Lorie Tarshis of the Stanford University and Mr. J. Downie of the Oxford Institute of Statistics, both of whom I had the privilege to meet at Poona about

the middle of 1955 at the Seminar in Advanced Economics arranged by the International and the Indian Economic Associations. To all these I extend my thanks.

I also thank Mr. M. Magimainathan, Clerk, Economics Department of the University, for typing the manuscript for me.

I am indebted in a special manner to the University of Madras not only for permitting me to publish this book but also for providing the right atmosphere for research. To the editor of the *Madras University Journal* (Humanities) I am grateful for permission to incorporate in this book the greater part of an article entitled "Price Trends in India since 1939" which I contributed to Vol. XXVI (1954-55) of the *Journal*.

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THE FACT that inflation continues to remain a live issue in our economy is, I feel, the main justification for bringing out a second edition of this book. The steady and in the recent few years, the rapid fall in the value of money has not only prevented the consumer from improving his standard of living to the extent increases in production would permit, but has also constituted a serious threat to economic progress itself. So long as economic development implies an acceleration in the rate of investment and in the spendings on capital intensive projects, inflation will be dogging at our heels and we have ever to keep a vigilant eye on this source of danger in our march towards our economic ideals.

In revising the book for the second edition I have kept in view this relationship between economic development and inflation. Most of the chapters in the First Edition have been revised and statistical data in all the chapters have been brought up-to-date. A new chapter has been added which outlines the effects of development finance on price level in the Second Plan years and examines the significance of the various indicators of inflationary pressures in the economy. I should here express my thankfulness to the Editor, *Indian Finance*, Calcutta, for permitting me to make use of an article published in that Journal of October 18, 1958. The research facilities available at the Madras University and the kind help which I have received from my colleagues in the Economics Department have made the task of revision easier for me.

D. BRIGHT SINGH

*University of Madras, June 1961*

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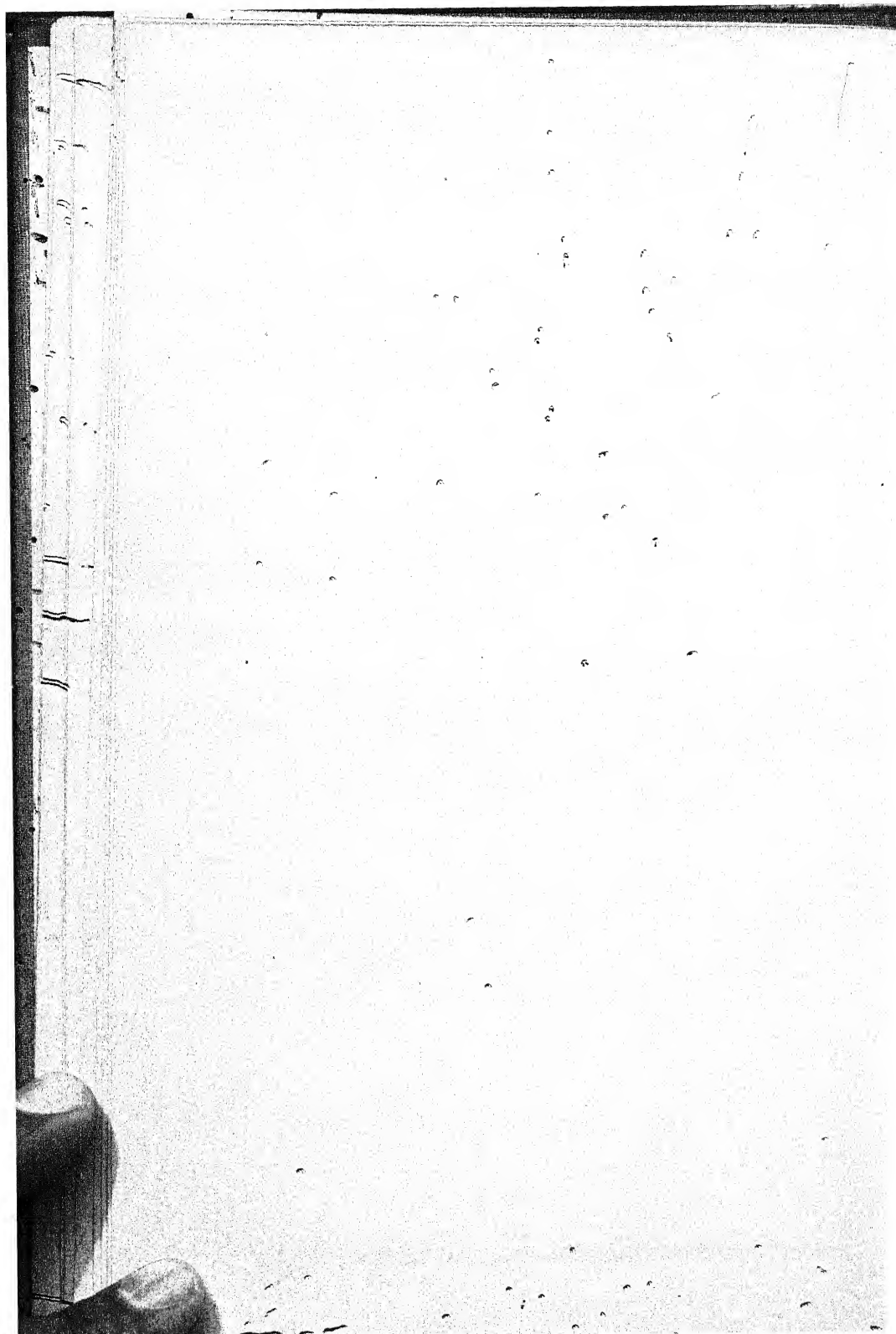
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INFLATIONARY PRICE TRENDS IN INDIA



## CHAPTER I

### THE ECONOMICS OF INFLATION

SINCE the out break of the Second World War in 1939 there has been on the whole a persistent uptrend in prices in India. During the War years price rise averaged 16 per cent per year. Between 1945 and 1951 it was 10 per cent ; in the subsequent years the average annual rise has been a little above 1 per cent. The rate of increase has, however, not been uniform within these three periods. About two years before the close of hostilities, it reached 42 per cent. In 1950 on the eve of the First Plan period it was 16 per cent; in the first year of the Second Plan 1956-57, the general price level rose by more than 10 per cent. Apart from this very significant rise in prices, there are other economic indicators which unmistakably point to the fact that highly inflationary conditions have prevailed in the country during the last two decades or so. If this high level of prices has not caused much concern, except in those years when the rise was particularly pronounced, the explanation should be found in the fact that the economy has nearly adjusted itself to a higher price plateau and the public have become accustomed to the experience of buying less goods with more money. Nevertheless, the danger of an inflationary situation getting out of hand is as real as ever before and the need for maintaining a stable price level, in the context of a developing economy with a Welfare State as the goal, should engage the attention of publicists and statesmen, especially in view of the fact that, while increased public expenditure on schemes of economic development is a helpful means of securing a larger national product, the keeping under control of an uptrend in the price structure, which usually follows in the wake of large annual investments, is a prerequisite for ensuring better distribution and enjoyment of the fruits of economic development.

In the following chapters an attempt is made to examine the general trend of prices in the war and post-war years and to study the causes and the social and economic implications of this inflationary price trend. But, to understand the significance of the movement of prices in India in recent years, it is necessary to have a general idea of the economics of inflation.

*The Meaning of Inflation*

By "inflation" "most people understand a substantial and rapid rise in the general level of prices".<sup>1</sup> Inflation is normally associated with high prices, because it is the rapidly shrinking value of the monetary unit that strikes the popular imagination easily. In reality, price rise is only a symptom of the disease and at times it is misleading too. Rise in the general level of prices is no more a necessary condition of inflation than a fall in prices is of deflation. The fact that in a state of repressed inflation prices are held down from rising by an efficient system of controls and rationing makes the situation no less inflationary. What happens under that condition is that inflationary pressure is held strictly under control, and therefore, hidden from public view, but the pressure is still there, dormant, but ready to manifest itself in the form of high prices the moment controls are relaxed or removed. Nevertheless, the common feature of inflation is a rise in the general price level and any definition of the term inflation should explain this phenomenon.

On this ground, it is possible to distinguish between two ways of defining inflation. Earlier writers based their definition on the well known Quantity Theory of Money and explained inflationary trends in prices in terms of an increase in the supply of money. Thus Irving Fisher in his book *Inflation*, has stated that supply of goods has not influenced prices as much as supply of money. After examining the price trends in Europe and the U.S.A., in the nineteenth and the earlier part of the twentieth century, he concludes that "price level almost invariably shifts with monetary factors — gold, silver, paper, credit — and very little with commodity factors. The latter control only the deviations of individual prices from the average price movement. In a word, supply and demand dictate each individual price relative to the price level, but money dictates the price level itself".<sup>2</sup> This is obviously an explanation of inflation in terms of money supply.

A logical step from a definition of inflation on these lines is to establish a cause and effect relationship between the volume of money on the one hand and prices on the other. When once it is admitted that money supply, more than the supply of commodities, determines the price level, it follows that an expansion of money,

<sup>1</sup> A. J. Brown, *Applied Economics*, 1947, p. 92.

<sup>2</sup> Irving Fisher, *Inflation*, 1933, p. 45.



attended with no commensurate expansion of the supply of goods, should result in an inevitable rise in prices. In this sense, "inflation occurs when the volume of money actively bidding for goods and services increases faster than the available supply of goods, when the growth of national income in money units is greater than its growth in physical units".<sup>1</sup>

But this definition, according to which expansion of money is the cause and rise in prices the effect, runs head on into hard reality. Anyone familiar with the literature relating to inflation in Germany in the early 1920's would be aware of the fact that in those confused times in Germany, prices, far from being pushed up by the volume of money, actually constituted the active factor drawing out into circulation an ever increasing volume of money. Prices then had risen a million million times and the cause and effect relationship between money supply and prices was reversed. Prices were increasing with such staggering rapidity that the rate of expansion of money supply could not keep pace with the demand for it. Publicists and writers of those times did not at all attribute inflation to increase in money supply. They rather emphasized the relative deficiency in the supply of money and found the cause of rise in prices in the unfavourable balance of payments position of Germany. Thus Helfferich in his work *Das Geld* (Leipzig, 1923), pointed out that depreciation of the German mark in terms of foreign currencies was the cause of the increase of prices and of the paper mark issues.<sup>2</sup> It is thus obvious that this definition of inflation as price rise due to excessive supply of money fails to fit in in a situation of hyper-inflation. It is in recognition of this apparent paradox that Dr. Paul Einzig has drawn a distinction between money inflation and price inflation. The first relates to that stage of inflation, the first stage as it were, in which over-expansion of money beyond the normal requirements for it pushes up prices; the second relates to the next stage, in which prices get out of control and rise so rapidly that money supply lags behind. And he defines inflation "as a state of disequilibrium in which an expansion of purchasing power tends to cause, or is the effect of, an increase of the price level".<sup>3</sup> This interpretation brings within the scope of the term inflation not only that familiar phenomenon of too much money chasing too few

<sup>1</sup> Goldenweiser, "Inflation", *Federal Reserve Bulletin*, April 1941, p. 291.

<sup>2</sup> Bresciani-Turroni, *The Economics of Inflation*, 1937, p. 45.

<sup>3</sup> Paul Einzig, *Inflation*, 1952, p. 22.

goods but also the other and the more vicious aspect of the problem of a wage, cost of production and price spiral in which each becomes at the same time the cause and effect.

A theory of inflation based on this definition and which attempts to explain inflation in terms of a relationship between money supply and price is at best a statement of one aspect of the problem. It indicates only that given a supply of goods, increase in the volume of active money facilitates larger spendings and thus leads to a rise in prices. This rise in prices caused by an over-expansion of money is called inflation. It is thus clear that this definition, while mentioning the factors which help in an inflationary price movement, does not explain the root cause of the trouble. A correct definition of inflation should indicate not only the factors responsible for an exceptional rise in price level but also show how these factors work themselves out and produce an inflationary situation. The theory of inflation, in short, should cover not only the static aspect but the dynamic aspect of the problem as well.

The quantity theory of money approach to inflationary analysis has a further serious defect. According to this interpretation, expansion of money supply attended with rise in prices is to be termed inflation. That this description of the situation is quite misleading and incorrect can be known from the fact that in a time of depression, if government resorts to the usual fiscal and monetary methods of counteracting the evils of depression, the result would be both an increase in money supply and a rise in prices. In fact, the methods are to be considered as a failure to the extent that expansion of money supply and activation of idle funds by a suitable monetary or public expenditure policy do not bring about a recovery in the price level and with that a regeneration of business activity. But it would be illogical and incorrect to describe such a rise in price level as an inflationary one.

In this sense the approach of the other group of writers to the problem of inflation should be considered as a corrective to the earlier one. To this group would belong Wicksell and Bent Hansen, the Swedish economists, and J. M. Keynes. According to these writers, "general price level is determined by the total demand for and total supply of the group of goods concerned, the prices of which determine the general price level".<sup>1</sup> And hence inflation is defined as that situation in which the total demand for goods, as shown by

<sup>1</sup> Bent Hansen, *A Study in the Theory of Inflation*, 1951, p. 2.



the volume of money offered, is in excess of the supply of goods at prevailing prices. In this analysis excess demand becomes the hall-mark of inflation and this concept is of basic importance in the analysis of inflation. Briefly put, excess demand represents the difference between quantity demanded and quantity offered at a given price. It applies both to commodities and services and also to factors of production, and shows itself in the form of a preparedness on the part of purchasers to pay a price higher than the prevailing one for a given quantity of goods. Excess demand is a common factor to both repressed and open inflation; in the first case it is camouflaged by control techniques, in the latter it appears naked in the form of excessive money prices.

It can be readily seen that there is not much difference in the basic premises of the two groups of writers indicated above, in so far as excess demand, which forms the cornerstone of the analysis of the latter group, can become effective only by means of increased money supply. But the essential difference between these two lines of analysis is to be found in the fact that, while the earlier quantity theory approach explains the position as it is, it fails to point out the origin of the trouble; the latter supply and demand approach not only indicates the source of the problem but also helps in visualizing the means by which the causal factors work themselves out in an inflationary process. However, it is possible to distinguish between the two lines of argument in explanation of the development of inflation according to these writers. Thus the Swedish writers and Keynes, in his *Treatise on Money*, trace the root of the problem to a difference between investments and saving. According to this analysis, an excess of investment over savings manifests itself in the form of an inflationary pressure in the factor markets, which then extends itself to the commodity markets as well. Thus, the essential point to be remembered about this analysis of inflation is that it points out excess demand in the factor markets as "an essential link in the chain of causation which leads to rise in commodity prices and factor prices".<sup>1</sup> As against this, Keynes, in his *How to Pay for the War* (1940), and others who accept the analysis of inflation contained in this book, emphasize the point that inflation takes its origin in the form of excess demand in the commodity markets. Price increase in the commodity markets then spreads itself to the factor markets.

<sup>1</sup> Bent Hansen, *A Study in the Theory of Inflation*, 1951, p. 18.

This difference, in emphasis between factor markets and commodity markets as the source of inflation, is of considerable importance from the point of view of the remedies which these explanations would suggest. Thus, if the trouble starts in the markets for commodities, then the logical and effective remedy should be increased production, better distribution, rationing and price control. But, if the other view is accepted, these remedies would be nothing more than palliatives which do not go to the root of the problem at all. If it is accepted that it is excess demand in the factor markets or overfull employment that leads to inflationary trends, then the remedy should be to freeze up the very source and fountainhead of this trouble. Thus, Professor Pigou points out that "when the volume of resources employed is given, inflation is necessarily associated with a rise in the rates of pay to productive agents, but not necessarily with a rise in the prices of services and goods received by final buyers".<sup>1</sup> On the basis of this analysis, a suitable wage policy is recommended as the most effective means of holding down inflationary pressure.

Current thinking on the subject makes a distinction between cost push and demand pull inflation. The first arises in a buyers' market when prices are pushed up faster than demand will permit. Cost rise is brought about mostly by a wage rate increase. A characteristic feature of such a situation is a simultaneous rise in costs, prices and unemployment. On the other hand if inflation is demand inspired, prices are being pulled up as a result of demand outrunning supply. When demand predominates in an inflationary situation the level of employment rises along with prices and cost. This distinction also has considerable significance in the matter of policy making. For, while restrictive monetary or fiscal policy will cut down excessive demand and thereby curb demand pull or buyers' inflation, it would prove to be a dangerous means of remedying inflation of the cost push type. In the latter case demand is not as high as entrepreneurs anticipate (otherwise they would not agree to wage rise) so that any restriction on spending would further bring down the level of employment and precipitate depression conditions.<sup>2</sup>

#### *Characteristics of Inflation*

Whatever may be the differences of opinion among economists

<sup>1</sup> A. C. Pigou, *Veil of Money*, 1950, p. 14.

<sup>2</sup> F. D. Holzman, "Inflation: Cost Push and Demand Pull," *American*

regarding the meaning of the term inflation and whatever the variations in emphasis on different aspects of the problem, there is a large measure of agreement in the recognition of certain features of the economic system as symptomatic of an inflationary situation. In the first place, the association in the popular mind of inflation with a rise in prices is based on observation of facts and is therefore essentially correct. For purposes of theoretical analysis, popular interpretations of economic issues may not often be useful or even be convincing or scientific; nevertheless, in this case, if we exempt such instances as repressed inflation, and the rise of prices from the depths of depression in consequence of government's monetary and fiscal policy, it would be found to be broadly true that excessive rise in prices has generally always been the hallmark of inflation. It is a well-known fact that during hyper-inflation in Germany, during the early 1920's, prices rose to unbelievably dizzy heights so much that money lost all its value and significance, and the disruption caused by inflation was such as to lead to momentous political changes. Nor can it be said that in the present day when techniques of monetary control and management have been developed to a high degree of perfection, the threat of inflation can be ruled out entirely. Towards the close of the last world war and in the years immediately following its cessation, inflation got quite out of control in countries such as China and Greece, and in some others hyper-inflation of the magnitude of what happened in Germany and Austria in the 1920's had developed. After World War II, prices in Hungary rose by 100,000,000,000,000,000 times, undoubtedly a record figure.<sup>1</sup>

Secondly, inflation is normally characterized by an excessive money supply. In times of war or other national emergency when the tax resources of the State are quite inadequate to meet the requirements of funds, governments resort to the banks which make advances on the basis of government bonds and securities. This leads to expansion in the volume of paper currency as well as of bank credit in the country. In the ultimate analysis, inflation of this type is a kind of forced levy, resorted to by many governments, without much qualms of conscience, because it is easy and can be

*Economic Review*, March 1960, p. 20, also A. P. Lerner "On Generalizing the General Theory", a review article in the same journal, p. 121.

<sup>1</sup> Seymour Harris, *The Economics of Mobilization and Inflation*, Norton & Co., New York, 1951, p. 95.

enforced by even the weakest of governments which can enforce nothing else.<sup>1</sup> Whatever be the objective of these measures, the effect is a rise in price and this for two reasons: firstly, the volume of consumption goods available for the public is restricted by government's competitive purchase; secondly, government in the very process of this acquisition puts into circulation a larger volume of currency. However, expanded money supply can affect price level only via the income stream. That is to say, the pushing up of prices by the competitive bidding of consumers is possible only if the consumers' spendable income increases. In reality, augmented money supply in the country transforms itself into increased purchasing power through increases in wages and salaries, increases in profits, capital appreciation, etc. It, therefore, logically follows that the secondary effects of increased money supply in the country can be effectively controlled by government if it takes steps to prevent money supply from working its way into increased effective demand for goods and services. In other words, by absorbing excess purchasing power with the public by means of increased taxation and borrowing and by an integrated system of wage and profit freeze, it is possible to scotch inflation very nearly at its source.

What has been stated above regarding the effect and working of money supply is suggestive of another significant feature of inflation, namely, its susceptibility to fall into two different stages. A moderate rise in price level is sometimes supposed to be in the interests of economic development. Price rise at this stage, although it would have within itself the potentialities of an inflationary spiral, is often times not regarded as inflation at all. But, if government is not vigilant, and the pressure of various economic rigidities prevents expansion of national product and, what is more important, government persists in its policy of monetary expansion, the inevitable next stage is reached when the rise in the level of prices gathers momentum and finally gets out of control. Professor A. G. Hart identifies the first as "excess demand inflation" and the second as "cost push inflation". He points out<sup>2</sup> that even if no decisive anti-inflationary measures are taken, inflationary trend would be normally checked to some extent by the following automatic factors:

(a) Faith in the national currency which helps savings;

<sup>1</sup> League of Nations, *The Course and Control of Inflation*, 1946, p. 65.

<sup>2</sup> A. G. Hart, *Defence without Inflation*, Twentieth Century Fund, 1951, pp. 71-5.



- (b) The influence of custom, which makes it difficult to alter some prices;
- (c) The shifting of income during inflation to those classes whose propensity to spend is less;
- (d) The restriction in government expenditure in consequence of a price rise;
- (e) The tendency for the proportion of spendable income to decrease as a result of increase in the yield of taxes during inflation;
- (f) Increase in liquidity preference which results in tightness of money.

It is, however, doubtful whether these factors can be really effective if expansion of currency and credit continues. In that case, it normally leads to a rise in the cost of the factors of production. As costs of materials and wages rise, the prices of finished products are pushed up. At the same time, the effective demand for finished products increases to the extent that income is raised. The chances of the second stage developing quite close upon the expansion of money supply are great in the present time of strong labour organizations. What is called "cost push" then exhibits itself in the form of wage boosting and price markups. The sequence of this trend is the development of the vicious wage-price spiral, the characteristic feature of runaway inflation.

While it is possible to distinguish between these two stages in any inflation of some magnitude, it is difficult or impossible to draw a clearcut line of distinction between the first and the second. For, even when inflation is quite "normal", seeds of hyper-inflation are there. The extent to which and the speed at which the second stage may develop depend upon the attitude and policy of the government and the general economic situation. It may be more appropriate to call these as two points in an inflationary process than as two stages. Yet, the fact that in the first stage money supply resulting from rise in demand keeps pace with price changes and in the latter, demand and price rise tend to outrun money supply, helps in identifying the two.

#### *Inflation in an Under-Developed Economy*

Inflation generally occurs in a situation in which there is an abnormal increase in effective demand exerted mainly by the government

as in a time of war. Financing of war either by taxation or borrowing or by expansion of money supply involves the restriction of consumption by the community and the increased use of the nation's resources by government for destructive purposes. Utilization of additional resources by the State in a time of war necessitates the curtailment of consumption by the people. Such savings are enforced on the people either by means of taxation or through deficit financing resulting in inflation. Even when the State resorts to borrowing, it is doubtful whether an element of force is not applied in the transfer of resources from individuals to the State. Increased effective demand of the State facilitated by monetary expansion works itself out into an inflationary pressure in two ways. First, to the extent that higher prices are offered by the government in competitive buying, the effect on general price level is direct. Second, the supply of resources available for private consumption is lessened. In either way, the result is a rise in prices. This rise in prices is in reality a means by which the required transfer of resources is brought about. The rise in prices following increased government demand reduces the real purchasing power of two important groups of the population. These are the fixed income earners, such as government employees, pensioners and people living on annuities, and also the large number of wage and salary earners whose incomes do not adjust themselves easily to fluctuations in prices. The rigidity in the money incomes of these classes of people means, in an inflationary context, that their real income is reduced. On the other hand, rise in prices directly benefits the entrepreneurial class whose real income is increased. But in so far as the propensity of the latter group to consume is much less than that of the former, the transfer of real income from the middle and lower income groups to the upper strata in effect means that the consumption in the community as a whole is pushed down. And the compulsory savings brought about in this manner are utilized by the State for its purposes—in this case waging the war.<sup>1</sup>

Essentially, inflation develops because of the lag between effective demand and output. However, increased utilization of resources by the State need not always be at the expense of consumption goods or resources available for the community. It is obvious that so long as unused natural resources are available, increased effective demand exerted by the State in a time of emergency, such as in war,

<sup>1</sup> Jan Tinbergen, *The Dynamics of Business Cycles* (Translated by J. J. Polak) 1950, p. 140.

would only result in the drawing up and utilization of these erst-while idle resources rather than in the encroachment on the stock of goods available for the consumption of the community. In other words, so long as full employment is not reached, increase in aggregate effective demand does not result in the pushing up of prices but only in raising the level of employment. When once full employment is reached, further increase in demand spends itself largely in raising the price level. Thus, in theory at least, inflation is not possible in an economy where there is unemployment or under-employment.

This, however, does not mean that there is no possibility of a rise in prices so long as there is less than full employment. In actual fact, prices rise as a result of expansion of demand even before full employment level is attained because of two factors:

(1) Additional money income generated by the increased demand of the State, as in a war, shows itself in the form of demand for both consumption and capital goods. Those who were hitherto unemployed get employment and earn income. The purchasing power of the community is increased; while at the same time, in so far as only part of the income is used for the production of consumption goods (the other part is used for producing capital goods), the supply of consumption goods in relation to the demand for them declines. This directly leads to a pushing up of prices.

(2) Increase in demand under less than full employment conditions normally draws into employment unused resources. But, the responsiveness of output to increasing demand progresses inversely to volume of demand and after a stage it becomes nil. This lack of perfect elasticity on the supply side, combined with other factors which help in pushing up cost of production, accounts for price rise before full employment is reached. The factors responsible for this sort of semi-inflation have been summarized by Lord Keynes as follows:<sup>1</sup>

- (a) Effective demand will not change in exact proportion to the quantity of money.
- (b) Since resources are not homogeneous, there will be diminishing and not constant returns as employment gradually increases.
- (c) Since resources are not inter-changeable, some commodities

<sup>1</sup> *General Theory of Employment, Interest and Money*, 1936, p. 296.

will reach a condition of inelastic supply, whilst there are still unemployed resources available for the production of other commodities.

- (d) The wage unit will tend to rise before full employment has been reached.
- (e) The remunerations of the factors entering into marginal cost will not all change in the same proportion.

These points indicate that as total demand increases, output does not increase in proportion because of certain rigidities in the economy, such as non-homogeneity of factors of production, inelastic supply of some of the factors, demand for and the successful securing of higher wages by labour, etc. all of which tend to push up the marginal cost. As a result of the development of these "bottlenecks" at various points in the structure of industry, it is prices rather than output or employment that tend to go up with monetary expansion and increase in demand.<sup>1</sup> In other words, to the extent that some of the factors of production are not completely mobile, inflation can and does occur before the entire economy is operating at full capacity. In reality, it is the actual supply and not the potential one that should meet increasing demand if inflation is to be controlled.<sup>2</sup>

In the light of this analysis, it is not surprising that highly inflationary conditions developed in an economy such as ours, in consequence of a continued rise in government spending during and after the Second World War, although the existence of unused resources and under-employment has been the characteristic features of this country as well as of others of her standard of development. While conditions of full employment and over-full employment were reached in advanced countries such as the U.S.A., it remains a fact that in India full employment has not been attained. A large volume of labour and resources remains idle for lack of chances for economic utilization. Unemployment in India, due to the transition from war to peace economy, has been estimated at well over a million.<sup>3</sup> In the years immediately following the end of war, both the volume of unemployment and prices have moved upward.

<sup>1</sup> Gottfried von Haberler, *Prosperity and Depression*, League of Nations, Geneva, 1937, p. 258.

<sup>2</sup> Goldenweiser, "Inflation", *Federal Reserve Bulletin*, April 1941, p. 292.

<sup>3</sup> United Nations, *Survey of Current Inflationary and Deflationary Tendencies*, 1947, p. 68.



A part of this unemployment in under-developed countries is normal frictional unemployment caused by such factors as introduction of machinery and changes in techniques of production, which oftentimes result in the displacement of labour.<sup>1</sup> This type of unemployment is not peculiar to under-developed regions but quite common in advanced economies as well and will remain. But apart from this, the apparently paradoxical situation of under-employment or unemployment existing side by side with inflationary conditions or even a synchronous worsening of both should be explained by two special and characteristic features of under-developed economies, namely, a more or less inelastic supply curve and the dependence of these economies on the export of raw produce. Increased effective aggregate demand would not cause inflation so long as resources are idle and so long as output can be increased in response to increased demand. In under-developed countries the propensity to consume is high and the percentage of national income saved is correspondingly small. Rapid increase in production is, therefore, doubly required if inflation is to be held down. But in actual fact, elasticity of output in these countries is low. This relative rigidity on the supply side is due to several causes. In these countries the demand for labour may be latent. But this demand does not fructify itself in the form of larger utilization of resources and increased production because of the scarcity of co-operating factors. The effect of inadequate imports of machinery, fertilizers and raw materials, and the lack of technical and managerial skill on production and prices in India in recent years is too well known to need any emphasis.<sup>2</sup> Generally speaking, increased investment in an agricultural economy does not lead to greater utilization of resources quickly and thus to full employment. Rapid response to increased demand would be found in the form of increased output only if there is unemployed factory equipment to match unemployed labour.

<sup>1</sup> In general, frictional unemployment is caused by miscalculation or intermittent demand or unforeseen changes, etc. (*General Theory*, p. 6); according to Lerner, frictional unemployment exists because the unemployed men and the skills and vocations do not match (*Economics of Employment*, p. 18); broadly speaking, frictional unemployment may be defined as one arising from certain structural factors in the economy (*U. N. Report on National and International Measures for Full Employment*).

<sup>2</sup> U. N. Department of Economic Affairs, *Survey of Current Inflationary and Deflationary Tendencies*, September 1947, p. 5; also U. N., *Economic Survey of Asia and the Far East*, 1947, p. 187.

To the extent that this is characteristically non-existent in under-developed countries, an increase in effective demand does not increase output or increases it very little and its main effect, therefore, is to cause prices to rise.<sup>1</sup> The peculiar feature of the economy of such countries is that while an initial investment would lead to higher output immediately, the secondary and tertiary effects of such investment are meagre. That is to say, increase in output is not maintained and the multiplier effect of the initial spending shows itself more in money terms than in real terms. Besides, high propensity to consume, far from assisting in a fuller multiplier effect, is actually conducive to a rapid rise in prices in so far the bulk of agricultural output does not come to the market for exchange. If propensity to consume is high it only means that a large volume of production will be consumed without it coming into the market at all, and supply in the market being less, price rise is the result.<sup>2</sup> Lastly, as Dr. V. K. R. V. Rao has pointed out, while in a developed country the existence of a margin of unemployment helps in increased output consequent on increased demand, this does not follow in a country, such as India, where there is disguised unemployment and under-employment. In other words, disguised unemployment is not responsive to effective demand as unemployment is. Such unemployment would exist even if there is greater demand for labour. To that extent supply would not increase and increased total demand exhibits itself in the form of higher prices.

Relative rigidity on the supply side in the face of increased total demand would by itself produce price rise of an inflationary type. This inflationary trend is reinforced by another factor in under-developed countries, namely, their dependence on the export of agricultural commodities. Increased effective demand would have no inflationary effect only if total output is increased. A large volume of the output of these countries is exported. That consists mostly of agricultural raw materials. Increased purchasing power in such a country leads directly to increased demand for articles of consumption. This includes to some extent imported goods. The demand for export goods has to come from the foreigner. Hence, to the extent that in a backward economy increased demand spends

<sup>1</sup> U. N. Department of Economic Affairs, *Measures for the Economic Development of Under-developed Areas*, May 1951, p. 41.

<sup>2</sup> Dr. V. K. R. V. Rao, "Income, Investment and the Multiplier in an Under-developed Economy," *Indian Economic Review*, February 1952, p. 59.

itself on imported goods and articles of home consumption, the possible expansion in the supply of export materials appears to have little influence on domestic inflation. In other words, a large sector of the national economy ceases to have any mitigating effect on the inflationary trend set in motion by increased effective demand.<sup>1</sup> Apart from this, in countries the economy of which depends largely on foreign demand for their export goods, the danger of an uncompensated increase in foreign demand for domestic products setting up an "export inflation" is great. An illustration of this is seen in the recent price trends in five countries of this group—Malaya (rubber, tin), Pakistan (cotton, jute), Ceylon (cocoanut products, rubber), Indonesia (rubber, tin) and the Philippines (abaca, cocoanut products). Increased foreign demand, as happened in 1950-51, swelled the incomes in the export industries. Higher incomes are first secured by exporters and profit takers whose higher expenditure raises the level of incomes throughout the economy; and as increased incomes are spent, domestic prices go up. Besides, as the export traders draw labour and materials from other industries, cost prices are pushed up, and speculative withholding of stocks of durable goods in anticipation of price increases worsens the position.<sup>2</sup>

### *The Effects of Inflation*

Although inflation implies a general advance in the price level, this rise is not uniform throughout the economy. Herein lies the danger of an inflationary trend of prices. A uniform rate of increase in the prices of goods and services in the different sectors of the economy would leave the relative position of the various earning groups unaltered. The economic effect of inflation then is neutral. But as a matter of fact, during any inflationary process, price trends of different groups of commodities and services vary not only in the rate of increase but also even in the direction of such change. The obvious and direct effect of diversity in the movement of different prices is a change in the pattern of income distribution in the community. It is this redistribution of income caused by inflation that is the source of so many evil effects normally attributed to an extraordinary price rise.

Inflation brought about as a result of excess demand of the go-

<sup>1</sup> U. N., *Economic Survey of Asia and the Far East*, 1947, p. 187.

<sup>2</sup> U. N., *Economic Survey of Asia and the Far East*, 1951, pp. 274-6.

vernment in a state of national emergency as during a war, amounts to a forced levy on the community and helps in the mobilization of resources to meet the emergency by restricting civilian consumption. From this special point of view, inflation is useful. Apart from this, inflationists claim that inflation benefits two important classes of people in the community who form the backbone of the nation's economy. These are the farmers and the entrepreneurial classes. It may be readily seen that both these classes of people benefit by an extraordinary price rise, mostly because they are primarily a debtor class. Repayment of debt in a period of inflation becomes easy in so far as while the face value of the debt obligations remains the same, the real burden falls directly in proportion to the fall in the value of money. Farmers benefit partly because the products which they offer for sale are highly inflation-sensitive, and partly because the costs which they incur in connection with their productive operations, such as interest charges, taxes, wages, etc. rise only to a small extent, at least in the early stages of inflation, in comparison with the prices of the products which they sell. In the same manner, the lagging of costs behind prices in the case of the business class swells up their profits. Besides, the appreciation in the value of his inventories constitutes another important source of the windfall earnings of the entrepreneur in an inflationary situation. The advocates of inflation find an overall benefit in the extra gains secured by particular classes of people, in as much as the state of feeling among these classes of people has a direct bearing on the national economy. It is claimed that the atmosphere of buoyant optimism that prevails among business classes encourages fresh capital investment, helps in the drawing up of idle resources for economic utilization and in increasing production to the maximum capacity of the economy.

The possibility of such developments cannot be denied. Nor can the advantage of these developments to the economy in the short period be disputed. But the danger of such a trend is two fold: firstly, as has been already indicated, an inflationary price trend, while in the early stages may be productive of certain economic benefits, involves also a redistribution of incomes in the community, which brings about serious economic repercussions. Thus the advocacy of a persistent mild dose of inflation in the economy is defective in so far as it is impossible to bring about a uniform adjustment in all incomes in response to the rate of inflationary



progress.<sup>1</sup> Secondly, those very forces which are helpful in encouraging capital formation and employment turn into adverse factors working in the opposite direction after a stage is reached. Recent statistical investigations carried out by an economist of the International Monetary Fund<sup>2</sup> point to the fact, that while no definite conclusions can be drawn, the evidence available broadly indicates that among the under-developed countries the rate of growth of the economy was higher when the rate of inflation was lower. In his study of the course of inflation in Europe in the nineteen twenties, Professor Ragnar Nurkse points out that the "success of inflation as an instrument of capital formation depends largely on the degree to which rise in prices is unforeseen and unexpected".<sup>3</sup> When a further rise in price is expected and seems certain, velocity of circulation of money increases, saving gives place to dissaving and inflation loses its capital forming power. Thenceforward there is a cumulative process of inflation. Thus with people acquainted with inflation and having the memories of hyper-inflation fresh in their minds, inflation in the Second World War progressed at a much faster pace and hence ceased to be of any value as a capital forming agency.<sup>4</sup>

Furthermore, even granting that during inflation people with flexible incomes such as entrepreneurs benefit, it is doubtful whether such benefits are real. At best, these advantages are of limited significance. To the extent the outlays of the farmer for labour and fixed expenses do not advance as rapidly as agricultural prices, the farmers as a class have an advantage. But this advantage is short-lived and oftentimes quite illusory. The relative inelasticity in the supply of agricultural produce, in the face of variations in demand, is the source of the farmer's profits in the uptrend as much as it is the source of his disaster in the downtrend. In fact, the greater hardship to which the farmer is put in a period of recession as compared to other producers, such as manufacturers, as a result of the rigidity of the cost structure with which he has to reckon, is directly proportional to the benefit which he enjoys in a period of boom. This is particularly so in countries where agriculture is highly com-

<sup>1</sup> Seymour Harris, *Economics of Mobilization and Inflation*, 1951, p. 255.

<sup>2</sup> U. Tun Wai, "The Relation between Inflation and Economic Development," International Monetary Fund Staff Papers, October 1959, p. 302.

<sup>3</sup> League of Nations, *Course and Control of Inflation*, 1947, p. 6.

<sup>4</sup> *Ibid.* p. 67.

mercialized and a large part of whose exports is agricultural products. Such countries are an easy prey to the dangers of an export inflation. In the ultimate analysis, there can be real benefit to the farmers only if agricultural prices rise while other prices remain stationary. This obviously is not possible. Normally, what makes the position of the farmers worse is that in a period of inflation they remain blissfully unaware of the temporary nature of the advance in prices. As a result, they develop a tendency to make fresh permanent investments on land in a period of boom. Land speculation then becomes common, as it did in the United States of America at the close of the First World War, with the result that when the reverse process sets in, the value of farm products as well as of land crumbles down, bringing in its train hardship, poverty and indebtedness to the class of farmers.<sup>1</sup>

Closely similar to the position of the farmer is that of the manufacturing class. The benefit which this class acquires in the form of higher profits when prices go up, has as much a windfall element in it as in case of the farmers; it is also equally transitory and is quite often much more illusory.<sup>2</sup> With a steady fall in the purchasing power of money, the propensity to consume on the part of the rank and file of the consumers declines. This growing consumer resistance, combined with the mounting costs of production and the necessity for replenishing stocks at inflated prices, makes the huge profits of the business class, at least in the later stages of inflation, more apparent than real. These benefits are in terms of money only. Before long, the profits of the manufacturers and traders begin to melt and evaporate in their hands or turn into losses. This fictitious character of the profit is, however, not adequately realized, and the entrepreneurs seldom understand that the payment of higher wages for labour and higher prices for materials and stocks out of inflated profits involves eating into their own capital resources.<sup>2</sup>

In reality, the evil consequences of an inflationary price trend are much more serious than the losses which they bring to the business classes and the farmers. From the economic point of view, it impairs productive effort in so far as it affects the labour, capital and managerial resources of the community. The declining value of money and the failure of the wage level to adjust itself to the price level leave the workers with a sense of frustration which directly

<sup>1</sup> Willis and Chapman, *The Economics of Inflation*, 1935, pp. 164-75.

<sup>2</sup> Paul Einzig, *Inflation*, 1952, pp. 142, 143.

cuts into the workers' incentives to produce more in order to earn more. At the same time, the feeling in the community that every unit of money that would be earned would exchange for a lesser and lesser quantity of goods destroys the saving habit of the people and places a premium on improvidence and careless spending. Besides, continued inflation or the knowledge that the government's budgetary or monetary policy would maintain inflationary forces for long, drives out capital from the country, as it did in France and Germany at the close of the First World War. Government's attempts to control movements of capital in such a situation are successful only to a limited extent. Thus a fairly high degree of inflation not only hinders capital accumulation but, what is worse, actually destroys the available capital resources or drives them out of the country. Nor is the attitude and behaviour of the entrepreneur class in an inflationary context favourable to increased production. Cost accounting, which is one of the chief ways of keeping production efficient in an advanced industrial economy, loses its meaning when the value of money changes frequently.<sup>1</sup> Business skill and efficiency tend to be used for speculative purposes rather than for productive purposes. And the chance of reaping windfall earnings out of the rapidly rising prices of existing supplies encourages hoarding and helps in the development of "gray" and black markets. In short, "inflation invites business to seek profits via manipulation of markets rather than via efficient production". Production also tends to be wasteful when the manufacturers find it possible to transfer higher costs onto consumers even if the quality of the product is not maintained at a high standard. Also, inflation makes the economy unstable when, as a result of the transfer of incomes which it involves from the middle and lower income groups to the higher income groups, the total consumption level in the community is brought down. The fear of a downtrend which takes hold of businessmen when boom has carried them to uneasy heights leads to contraction of inventories and capital expenditure that would precipitate the very crisis which the business class would be anxious to avert at all costs. Lastly, decline in foreign demand, in consequence of inflation in the exporting country, reduces out-

<sup>1</sup> A. G. Hart, *Defence Without Inflation*, 1951, p. 13. "When prices are rising fast the accountant's costs may get out of touch with the current situation. Consequently management cannot safely gauge the efficiency of operations by their cost showing".

put and employment in the exporting industries first, and then spreads to the other sectors and engulfs the whole economy.

Since the effect of inflation on the incomes of different classes of earners varies, it is productive of serious social consequences. In general, it swells up the money incomes of the flexible income earners and adversely affects people with fixed incomes, such as pensioners, government employees and to some extent labourers. Among the last class, those who are well organized are hit less hard than others. The investor in equities benefits, while those who invest their funds in fixed interest yielding bonds are seriously affected. When it is realized that most of the middle class investors choose fixed interest bearing securities, insurance and savings accounts, the effect of inflation on the small investor is obvious.<sup>1</sup> Thus the redistribution of wealth involved in inflation lays a burden on those classes least able to bear it. It widens the gulf between the higher income groups on the one hand and the middle and lower income earners on the other. Such a redistribution of incomes causes serious class ill will and social conflicts and the emergence of a sellers' market, and the abundant chances of making profits through unfair means lower the standard of commercial morality and produce serious heart-burning among vast sections of the community who find that rewards go to unpatriotic people, while the cautious and the conservative are penalized.<sup>2</sup>

The political danger of inflation consists not only in the social ill will and the chances for class conflict that it produces, but what is more important, in the fact that it denotes and implies weakness in political discipline. The fact that in the Second World War inflation took a serious turn, not in those countries directly involved in war or in those where money supply was increased to a greater degree, but, in those whose administrative systems were less efficient and where for that matter, an effective control machinery could not be organized, lends support to this view. Besides, in an inflationary situation, the revenues of the State and local governments fail to respond to the growing responsibilities of the State. It has been shown that even in the U.S.A., while the gross national product between 1938 and 1946 nearly doubled, the State and local receipts

<sup>1</sup> K. Kurihara, *Monetary Theory and Public Policy*, 1951, p. 56.

<sup>2</sup> For an account of the hardship caused by inflation to middle class fixed income earners in Germany in the early nineteen twenties, see J. W. Angell, *The Recovery of Germany*, 1929, pp. 38-9.



increased only by 26 per cent and expenditures only by 10 per cent. This is largely so in the case of State Governments which get a good proportion of their tax revenue from inflexible sources, such as a land tax. The result of this is seen in the starvation of developmental services, such as public works, education and public health, on which depend largely the growth and prosperity of the national economy.

The evil effects of inflation are of special significance to an under-developed economy such as ours. Economically backward countries, which have launched upon programmes of industrial and agricultural development, are specially susceptible to the inflationary danger for the following reasons:

Firstly, the pattern of economic development which these countries envisage and the method of financing it constitute an important source of inflation. Most of the under-developed countries which have awakened to the need of economic development have only recently emerged from a colonial status. They have before them as models well-developed economies which are highly industrialized. Rapid industrialization is, therefore, their main goal. For them industrialization is almost synonymous with economic advancement. But since these countries lack adequate entrepreneurial skill, and the organizational set up necessary for growth, the burden of giving a start to industrialization and development has devolved on governments. Besides, only governments can afford to make the huge initial investment needed for providing the various overhead facilities. To the extent that government plays a prominent part in the development of the economy, a rise in total investment is accounted for largely by government outlays. Investment involves the utilisation of real resources for purposes of capital formation. If government investment is to increase, real resources normally used for consumption or investment in the private sector must be transferred to the public sector. If the demand for these resources in the private sector remains the same, then government's increased investment represents an addition to total normal demand. In other words, increased investment by the government causes an excess of aggregate demand over the normal supply of resources. Now, if government by means of physical controls or other direct measures restricts consumption or demand in the private sector, the transfer of real resources to the public sector can be effected without any rise in prices. On the other hand,

if this transfer is to be brought about through the normal market mechanism, then government would have to find the means of buying these resources; that is, government will have to use its past savings or issue currency or borrow from the central and commercial banks. This can lead to an inflationary trend in prices.

The second factor that tends to foster inflationary conditions, in the early stages of economic development, is the existence of certain rigidities in the economy such as lack of technical skill, capital equipment, inadequate transport facilities, etc. Obviously, if excess demand should not exert a pressure on the price front, there should be a proportionate increase in the supply of both consumption goods and industrial raw materials. The fact, however, is that owing to the rigidities mentioned above, the output of the under-developed countries is less responsive to increases in purchasing power than economically advanced countries. This lack of responsiveness on the supply side to increased demand swells up money incomes rather than real incomes. In other words, the initial spending by government on development projects exerts its force on the price level rather than on production. It should also be added that in so far as much emphasis is laid on industrialization, economic growth with price stability is possible only if the supply of raw materials is sufficiently increased. Otherwise, when there is a relative shortage of primary products, the economy experiences a rise in wholesale prices. Manufacturers of final products raise the price of their goods in response to rise in costs; the cost of living goes up, and wage earners press for higher wages. This further raises costs of production, and other money incomes also go up, resulting in a full-fledged inflation.

Thirdly, development programmes in under-developed countries are concentrated of necessity on the production of capital goods or producers goods rather than on the production of consumption goods.<sup>1</sup> Thus, while the money incomes of the community go up because of increased spending by government, the inadequacy of consumption goods to meet the increased demand set in motion by the higher purchasing power helps in the pushing up of the general price level.

<sup>1</sup> "The Colombo Plan", *The Second Annual Report of the Consultative Committee on Economic Development in South and South East Asia*, New Delhi, October 1953, p. 96.

Fourthly, if a mild dose of inflation is supported on the ground that it helps in transferring incomes into the hands of potential investors, it has to be remembered that in order to bring about such a transfer a larger dose of inflation is necessary in an under-developed economy than in a developed one. Given a rise in prices the extent of the transfer depends on the propensity to save and consume of the profit earners and wage earners. If the marginal propensity to save out of profits is high the price rise required would be correspondingly less. It is doubtful whether the marginal propensity to save of the business classes in the less developed countries is equal to that of their counterparts in a developed economy. Furthermore, since the transfer of resources is from wage earners to profit earners, the extent to which this transfer can be effected depends also on the proportion of wage income and profit income to total income. The ratio of wages to profits is much lower in the under-developed than in the developed economies. In the U.S.A. and U.K., it is 2.1: 1 and 2.3: 1 while in Ireland and Chile, it is 1:1 and in Kenya it is 0.6:1. Since the base out of which the transfer is to be made is relatively smaller, it is necessary to have a greater rise in prices in an under-developed country to achieve a given transfer of resources than in a developed economy.

Fifthly, in these countries the means to control potentially inflationary situations brought about by public expenditure are not quite effective. While factors that might mitigate the impact of inflation, such as reserve capacity in consumer goods industries or foreign reserves, are lacking or inadequate, there exists neither an efficient apparatus of controls nor a taxation system capable of taking up automatically substantial parts of the increments in income brought about by increased government spending.<sup>1</sup>

It is these factors that make the danger of inflation real in under-developed countries which have adopted a policy of increased spending by government in order to attain rapid economic development. In this sense their significance to India at the present time is obvious. But, apart from these, the fact that India has as her objective the establishment of a Welfare State and is shaping her developmental policy in accordance with that ideal leaves the country particularly exposed to the inflationary threat. Some of the social measures which a Welfare State would normally adopt have a high degree of

<sup>1</sup> U. N., *Survey of Current Inflationary and Deflationary Tendencies, 1947*, p. 5.

inflationary potential. These include attempts at securing full employment, shorter working hours and paid holidays, payment of high wages, increased State spending on social services, etc., some of which have a definite tendency to push up cost of production and thereby raise prices. The peculiar danger of inflation in a Welfare State consists in the fact that inflation brought into being by the government's economic and social measures would hit particularly hard the middle and lower income groups, those very classes of income earners in whose interests such measures are taken and who are the least capable of defending themselves against the evils of an inflationary price trend.

The chances of inflation are not only greater in under-developed countries than in well-developed ones, but the consequences resulting from it are also more serious in the former group of countries than in the latter. Besides, the general evils indicated earlier, which affect developed as well as undeveloped economies, the latter have to take special care against one great danger of inflation, namely, the threat to capital accumulation. The great need for capital formation in these countries cannot be exaggerated. But the fact that inflation specially hits the small investor shows that it would block the principal source of capital available at home in backward economies. Besides, inflation distorts the profitability of various types of enterprise and encourages people to put too much capital into speculative enterprises and into hoards of gold and foreign exchange. Inflation also discourages the inflow of foreign investment which is particularly important to under-developed countries.<sup>1</sup>

<sup>1</sup> U. N. Department of Economic Affairs, *Measures for the Economic Development of Under-developed Countries*, May 1951, p. 42.



## CHAPTER II

### WAR-TIME PRICE TRENDS, 1939-1945

#### *Price Position on the Eve of the Second World War*

THERE is a general uniformity in the international price trends during the years immediately after the Great Depression of the early nineteen thirties. From 1932 onwards, there was a significant revival in economic activity marked by a general upward movement of prices, higher levels of employment, increased production and an accelerated tempo in international trade. This upward trend received a set-back in 1937-38 which affected almost all countries of the world, with the exception of Japan where conditions arising out of the exigencies of the Chinese War were peculiar. In the latter part of 1938, however, there were signs of revival, but the adverse turn which international relations had taken at this time undermined both political and business confidence, with the result that something of an international economic crisis set in with all its characteristic features, such as price recession, fall in industrial production and in the level of employment, decline in stock exchange prices and violent fluctuations in exchange rates. This recession in its turn gave place to general business optimism and increased economic activity just before the outbreak of war in September 1939.

This general pattern is observable in the economy of the two leading countries of the world with which India has an intimate trade relationship. After the recession of 1937-38, beginnings of a recovery were visible in the U.S.A., in the latter part of 1938. The index number of industrial production rose from 76 in May 1938 (1923-25 = 100) to 104 in the last month of that year. In the same year employment figures showed an improvement of 4.5 per cent. Industrial shares, however, after improving till November 1938, again receded in December which indicated the trend of general price level also. In the United Kingdom the index number of business activity (1935 = 100) moved up from 102 in May 1938 to 105.5 in March 1939. There was a synchronous improvement in industrial production as well, but wholesale prices maintained a steady but slow decline. Along with that, Britain's external trade also suffered, with exports and imports of merchandise declining

by 10 per cent in 1938. But in the first half of 1939, the rearmament programme, which was intensified in view of the worsening international situation, helped in the revival of certain industries in the country. Production in pig iron and steel improved and certain industrial shares registered a recovery. Business trends on the whole indicated an improvement.

Being a primary producer, India was quite seriously affected by the slackening of foreign demand for raw materials. Between August 1937 and April, 1938 decline in prices in India was greater than in the U.S.A. and much more marked than in the United Kingdom. It was 10.5 per cent in India as against 10 per cent in the U.S.A. and 7.4 per cent in the United Kingdom. Although in the year 1938-39 the index number of wholesale prices improved, yet, towards the close of the first quarter of 1939 there was a downward shift. Thus, the Calcutta wholesale prices index number (July 1914 = 100) moved up from 67 in March 1938 to 69 in February 1939, but came down to 68 in the next month. A more or less similar trend is indicated by the Bombay index number also. Furthermore, this general trend in the wholesale price indices hides the sharp fluctuations in the prices of staple export commodities consequent upon the mounting international political strain. Between March 1938 and March 1939, price indices for raw cotton, cotton manufactures, oilseeds, tea, and hides and skins receded by 6 to 11 per cent, while cereals, sugar and jute (raw and manufactured), appreciated to a significant extent.

Thus, the price position in India, as elsewhere, just before the outbreak of war, was unstable. The fluctuations in prices were mostly due to psychological factors brought into play by the tense international situation. One significant fact that may be noted is that even before the outbreak of war, some industries in all these countries showed signs of recovery with the acceleration of the armaments programme.

#### *The Different Phases in the War-time Price Movements*

In August 1945, which witnessed the surrender of Japan and the return of peace, the Economic Adviser's index number of wholesale prices in India<sup>1</sup> stood at 244.1. This rise in the general level of prices by 144 points since 1939 was not uniformly spread over the six years, there being considerable variations in the rate of increase

<sup>1</sup> Week ending 19th August 1939 = 100.



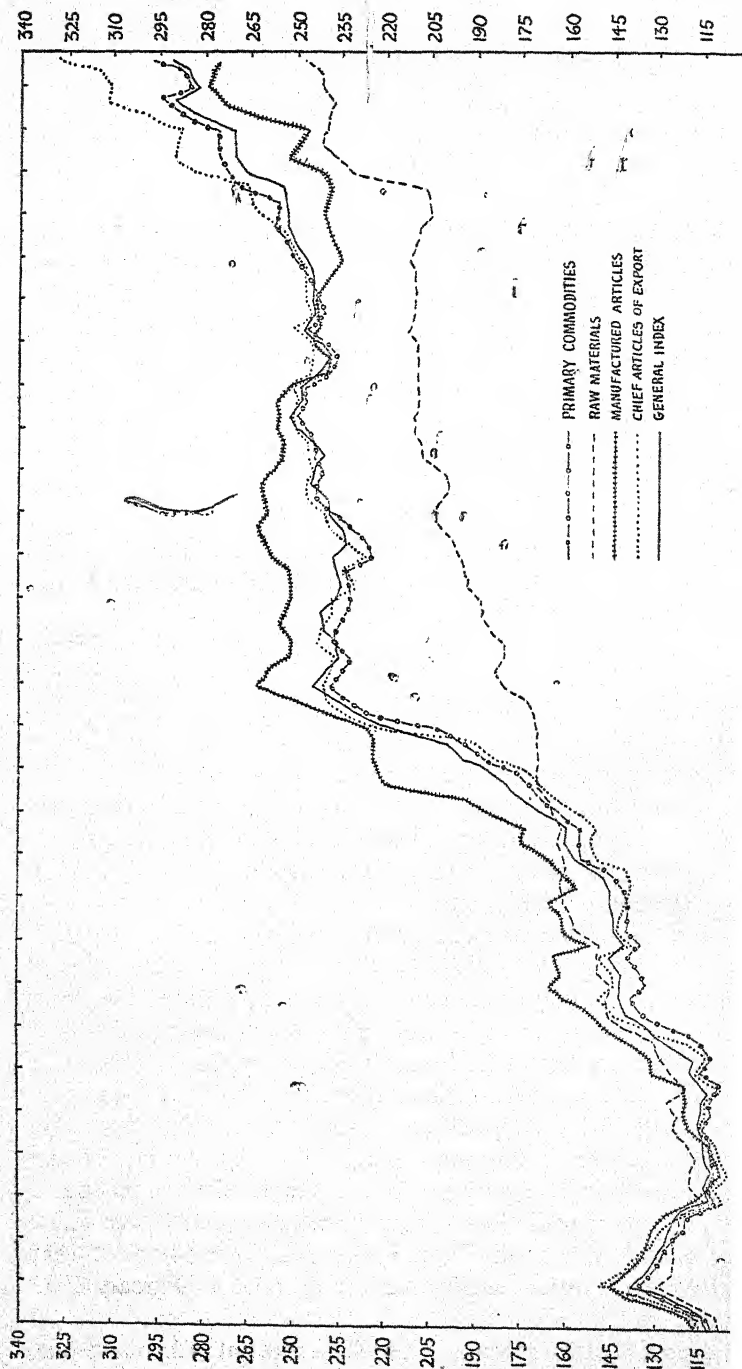
from year to year. Nevertheless, three distinct phases in the movement of prices during the war period can be discerned. First, the speculative boom and crash covering the period September 1939 to August 1940. In the course of these twelve months the general index mounted upto 198.3 in December 1939 and returned to 108.4 in August 1940; second, the period of comparatively steady rise from August 1940 to June 1943 when the general index reached 241.7 points; third, the period of relative stability between June 1943 and the end of the war, August 1945. Chart I illustrates these three phases in the movement of war-time prices in India.

(a) *The Speculative Boom and Crash* (September 1939 to August 1940)

There is a difference in the pattern of price trends in India during the world war of 1914-18 and that of 1939-45. In general, the rise in prices in the First World War was more gradual in the first three years. As compared with the pre-war level, the index number of commodity prices advanced by only 12 points in the first two years and by only 28 points during the first three years. Acute inflationary pressure set in only towards the close of the war in 1917 and in the years immediately following the armistice. On the other hand, in the Second World War, there was a sharp upward thrust in the price index soon after the outbreak of hostilities. In the first five months of war the general index of prices went up by 38 points. For more than a decade after the second year of war price level continued to rise but with considerable fluctuations in the upward movement.

Even before the outbreak of hostilities, the worsening international situation and actual preparations for war resulted in an increased demand for raw materials which helped in the rise of raw material prices all over the world. In India the index number of wholesale prices (base 1873 = 100) which was moving around 131 since the second quarter of 1938, suddenly spurted to 137 in May 1939, four months before fighting commenced. That higher prices of raw materials were largely responsible for this sudden rise can be known from the fact that while in the first six months of 1939 the index number of the price of raw cotton advanced from 64 to 71, that of cotton manufactures steadily declined from 93 in January 1939 to 88 in August.

This export boom in raw materials which accounted for the rise in



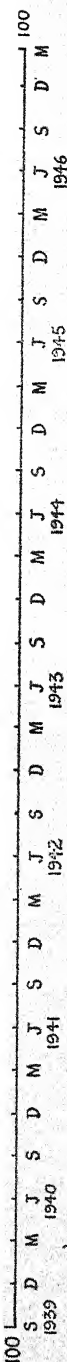
prices in the few months preceding the outbreak of war received a sharp check when hostilities actually opened. With the difficulties of obtaining freight and insurance, overseas trade came to a standstill and exporters met with serious losses because they were forced by circumstances to unload their purchases in the local market at a loss. This, however, was a very temporary phenomenon. It soon disappeared in a speculative deluge. This speculative demand which in reality was a hoarding demand, covered almost all groups of commodities, raw materials, manufactured articles and even imported goods. The race for the accumulation of stocks started and with that prices shot up owing to the belief on the part of the businessmen and traders that the intensification of economic warfare would mean brighter prospects for Indian industries and agriculture. The hoards were built up with the hope of making enormous profits when supply declined or dried up and demand increased in future. The result is seen in the mounting up of the general index-number from 100.3 in August to 138.3 in December 1939. This spurt in commodity prices showed itself in all centres of the country. In Madras, the price of rice, the chief item of food, went up by 10 to 20 per cent, the wholesale price of sugar rose by 30 per cent, castor, cocoanuts and copra, important articles of export, by 40 to 50 per cent and cocoanut oil by 64 per cent.

The rise in prices consequent upon speculative demand was not peculiar to India, but, common to most countries of the world. There is, however, one special feature about this sudden price rise in India. In this country increase in prices covered all groups of commodities — food articles, raw materials, manufactured articles, import goods and export goods. This may be seen from Table 1.

The figures in the table show that just a month after the outbreak of war food articles moved up from 110 to 121 (Bombay Index) or increased by 10 per cent. Raw jute and cotton gained 19 and 16 points respectively (Calcutta Index). There was a spectacular rise in the prices of jute manufactures and other textiles as well. Export goods, like hides and skins, and metals, were no exception.

As against this, in many other countries which experienced a similar boom, the rise in prices was not general, but concentrated mostly on raw materials. According to the *League of Nations Monthly Bulletin of Statistics* for February 1940, the prices of most of the primary products of the world, such as maize, hogs, linseed and cotton seed oil, cotton, raw silk, rubber, timber, crude petro-

Chart I: Index Numbers of Wholesale Prices, 1939-46 (Base : 19th August 1939=100).



leum, copper, lead, silver, etc. went up much more rapidly than the prices of manufactured articles with the result that the price discrepancy between these two groups of articles, which had been widening in many countries since the collapse of raw material prices in 1937, narrowed down considerably by the end of 1939.

TABLE 1  
INDEX NUMBERS OF WHOLESALE PRICES

(Base: July 1914=100)

| Articles                               | Calcutta       |                 | Bombay         |                 |
|--|----------------|-----------------|----------------|-----------------|
|  | August<br>1939 | October<br>1939 | August<br>1939 | October<br>1939 |
| <i>Foodstuffs</i>                      |                |                 |                |                 |
| Cereals                                | 83             | 93              | 88             | 95              |
| Pulses                                 | 96             | 104             | 95             | 108             |
| Foodgrains                             | —              | —               | 89             | 98              |
| Sugar                                  | 152            | 161             | 136            | 158             |
| Tea                                    | 140            | 152             | —              | —               |
| Other food                             | 114            | 155             | 154            | 164             |
| All food                               | —              | —               | 110            | 121             |
| <i>Raw &amp; Manufactured Articles</i> |                |                 |                |                 |
| Oilseeds                               | 101            | 107             | 95             | 98              |
| Raw jute                               | 57             | 76              | —              | —               |
| Raw cotton                             | 64             | 79              | 67             | 76              |
| Jute manufactures                      | 79             | 126             | —              | —               |
| Cotton manufactures                    | 97             | 107             | 88             | 92              |
| Other textiles                         | 90             | 168             | 83             | 83              |
| Hides and skins                        | 63             | 74              | 99             | 99              |
| Metals                                 | 142            | 153             | 131            | 227             |
| Other raw and manufactured<br>articles | 93             | 103             | 120            | 130             |
| Teak wood                              | 121            | 123             | —              | —               |
| All non-food                           | —              | —               | 99             | 122             |
| <i>All Commodities</i>                 | 100            | 118             | 103            | 121             |

Towards the close of the first quarter of 1940, the general rise in price level which had followed the outbreak of war had been stopped or reversed in a number of countries, in particular in the large raw material producing countries — South Africa, Argentina, Canada



and the United States. In India, the initial spurt in the price level which commenced from the first month of war had nearly spent itself by June 1940. Prices reached the peak level in the first phase of the price movements in India in December 1939 when they were 38 points higher than in August 1939. Since then there was a decline. The ostensible causes for this reversal, cited by government representatives, were the price control measures adopted by the Central and Provincial Governments and the publication of the Excess Profits Tax Bill on the 27th January 1940. Doubtless the fear of increased government control of prices and the realization that with the coming into force of the Excess Profits Tax, a large slice of the income from business would be appropriated by the State had a dampening effect on business activity in general and thereby kept prices from going beyond control. Yet, the real factors responsible for the down turn in the first half of 1940, which was as spectacular as the uptrend in the preceding four months, were partly the natural reaction to the speculative boom and partly the political developments in Europe as the war got into its full stride. There was the general feeling that the initial rise had been overdone. The hoarding demand had reached the saturation point and its decline affected total demand. The dishoarding of a large amount of accumulated stocks caused some sort of a temporary glut in several sectors of the market with the result that prices came crumbling down. Furthermore, the virtual loss of all external markets to India with the exception of Great Britain consequent on the intensification of war, seriously affected business prospects in the country, so that from the beginning of 1940 the commodity markets were in a subdued condition. The situation worsened in May and there was panic in almost all the share and commodity markets and prices came down rapidly under heavy selling pressure. The developments in Europe, in June 1940, introduced a feeling of uncertainty in the business world and the prices of most staple commodities registered a sharp downtrend and in some cases reached their pre-war levels. Naturally, export articles were hit the hardest. Thus, in the first six months of war, the index number of the price of raw jute declined from 130 to 80, jute manufactures from 172 to 94 and raw cotton from 122 in December 1939 to 68 in June 1940; in the same period cotton manufactures fell by 16 points and oilseeds from 126 to 97, i.e. by 29 points. The more marked decline in the prices of export articles suggests that loss of foreign markets and reaction to speculation were res-

possible for the recession in prices in a greater measure than early government attempts at control.

(b) *Period of Rise* (August 1940 to June 1943)

While the speculative factor had spent its force in less than one year, there were other long sustaining forces at work which asserted themselves in the latter half of 1940. These factors, essentially of a war-time character, set in motion an upward trend which continued till towards the middle of 1943. Although the general tendency was upward, the rise was neither steady nor continuous, there being periods of slow increase succeeded by periods of quite rapid rise. On the basis of the rate of increase, it is possible to distinguish four different stages in this three-year period. Between August 1940 and April 1941, the rise was slow, the general index moving from 108.4 to 116.4. Between these two points of time agricultural commodities remained on the whole low but with considerable fluctuations touching the low level of 94.5 in February 1941 and reaching the maximum of 107.1 in September 1940. On the other hand, industrial raw materials and manufactured articles showed a rather steady upward trend. Between April and August 1941 all groups moved up, but agricultural commodities, which hitherto lagged behind the general index, jumped from 103.2 in April 1941 to as high as 152.7 in August—a rise of 48 per cent in the short period of five months. After a sharp decline in December 1941, shared by all groups, the upward trend continued in the third stage December 1941 to April 1942; but the rate of increase had considerably slackened. In the last phase of this period from April 1942 to June 1943 there is again a steep rise. During this period manufactured articles went up by 59 per cent and agricultural commodities by 67 per cent, while the general index moved from 145.9 to 241.7, a rise of 66 per cent.

The rise in the price level during the three-year period — mid 1940 to mid 1943 — was quite significant, and the factors responsible for this rise paved the way for a dangerous inflationary condition in the country. Nevertheless, the seriousness of the situation was not realized at this stage. In fact, the rise in prices was welcomed by the business classes in so far as it represented a recovery from the effects of the depression of the nineteen thirties. The substantial gains made by businessmen, as a result of the decline in imports and



increased local or war demand, were welcomed and justified on the ground that the surpluses thus accumulated in the war period would stand the manufacturers and traders in good stead in the difficult period of reconstruction after the war.<sup>1</sup> In view of this attitude of business towards price trends, it is not surprising that the Reserve Bank remained quite unperturbed. In its Report for the year 1940-41 the bank remarked, "A general review of comparative price trends since the outbreak of war, indicates no tendency of an abnormal or inflationary rise in prices in India and the rise that is evident from the figures would appear to be incidental to the general disequilibrium in production and trade caused by war".<sup>2</sup> Nor was government's attitude different. Although cost of living had nearly doubled itself at the close of 1942 since the outbreak of war<sup>3</sup> and there was increasing pressure put forth by the employees in mines and factories as well as in government service for higher wages and dearness allowances, and although such allowances had begun to be granted, even in 1940 and had been raised in the following years, government does not seem to have woken up to the inflationary potentialities of such a situation. Its attitude was mostly a wait and see one. Annual price control conferences had been called together since October 1939 with the view, ostensibly, of holding the price line and thus relieving the distress among the wage earners and the fixed income groups, yet nothing material was done in these conferences and the upward tendency of prices continued.

In reality, the movement of prices was haphazard and unsteady so that while a certain section of the people benefited, others suffered. Throughout this period of rising prices, manufactured articles maintained a higher level than primary products. The explanation is to be found in the fact that with the worsening of the war situation and the spreading of hostilities to the Far East also, imports of foreign manufactured goods practically stopped. In view of the shortage of capital equipment and the difficulty or even impossibility of importing capital goods from outside, the manufacturing concerns in India were not in a position to cope with the situation created by the swelling unsatisfied consumer demand at home. Besides, owing

<sup>1</sup> *Commerce*, 15th March 1941, p. 309. \*

<sup>2</sup> *Report on Currency and Finance*, 1940-41, p. 5.

<sup>3</sup> Between August 1939 and December 1942, the Bombay cost of living index rose from 105 to 188 (1934 = 100), the Madras cost of living index from 98 to 158 (1936 = 100), and the Kanpur cost of living index from 100 to 224 (August 1939 = 100).

to acute pressure on the railways and general transport difficulties, it was not possible to ensure proper distribution of the limited stock of the manufactured consumption goods. On the other hand, the prices of raw materials did not go up to the same extent because, although there was an expansion in war demand, the transport of these goods across the seas to foreign markets became an insurmountable difficulty. Thus agriculturists were for quite a long time in an unenviable position. The overall result of this situation was that the economy of the country as a whole did not benefit by this rise in prices. This feature was common to all agricultural and less developed countries whose exports are mostly primary products and their imports mostly manufactured articles. Thus in Argentina, in the second and third years of the war the prices of agricultural products, which constitute the bulk of the country's exports, were severely affected by the loss of European markets. They dropped by 15 per cent between August 1939 and January 1941, while non-agricultural goods went up by 28 per cent during the same period. The effect of this is seen in the adverse balance of trade position of countries belonging to this group.

Apart from deficiency in production, particularly in the industrial sector which itself was due mainly to transport bottlenecks and shortage of capital equipment, one of the major factors responsible for accelerating the rise in the general price level in 1941 and 1942 was the expansion in money supply. Between August 1939 and September 1943, currency notes in circulation in the country increased from Rs. 169 crores to Rs. 760 crores or by more than four times and the demand deposits of scheduled and non-scheduled banks went up from Rs. 141 crores to Rs. 473 crores or by nearly three and a half times. Although such an increase in money supply was quite a common feature in most of the countries, yet the rate of increase in India was among the highest as shown in Table 2.

In India the expansion of currency was facilitated by the method of financing British purchases in the country.<sup>1</sup> The new purchasing power, released by the Reserve Bank, first found its way into the hands of military contractors and others with whom government had direct contact and helped initially in the rise of prices of articles directly required for war. Subsequently, when the supplies of such goods had enhanced purchasing power, the effective demand for foodstuffs and all other goods increased and the general price level

<sup>1</sup> See for details Chapter V, p. 112.

was pushed up. With every such increase in the general level of prices, government had to put more money into circulation in order to get the same quantity of goods, so that inflationary pressure gathered momentum at every turn and the prices went up in a snow-ball fashion.

TABLE 2

INCREASE IN NOTE CIRCULATION BETWEEN THE END OF  
1939 AND THE FIRST QUARTER OF 1943

| Country        | Percentage of rise |
|----------------|--------------------|
| Switzerland    | 24                 |
| Sweden         | 35                 |
| United Kingdom | 67                 |
| Germany        | 106                |
| U.S.A.         | 114                |
| Australia      | 118                |
| Belgium        | 154                |
| France         | 163                |
| India          | 179                |
| Canada         | 209                |

(Source: *Commerce*, 18th September 1943, p. 408.)

It is obvious that expansion in money supply was necessitated by the large demands arising out of the exigencies of war. And the inflationary pressures in the economy, in this period, were partly the result of this excess demand and partly of the shortage of materials and goods needed for domestic production and civilian consumption. It, however, appears strange that the implications of this demand and monetary factors failed to impress sufficiently the government or the monetary authorities in the country. As late as the middle of 1942, Sir James Taylor, then Governor of the Reserve Bank, argued that rise in prices was not due in the main to currency expansion, but due to non-monetary factors, such as the failure of the Provincial Governments to enforce control measures in conformity with the requirements of the Central Government, transport difficulties, large purchases made by the British Government and the high prices paid by the Supply Department in respect of purchases made by it on behalf of the government. Similarly, the Finance

Member, in his speech introducing the Budget for 1943-44, stated that the rise in prices was due to shortage and hoarding of goods and not due to currency expansion.<sup>1</sup> In effect the purchases of the British Government meant only the lending of real resources by the Indian Government to Great Britain; and in so far as this lending was not matched by real savings in the country but involved an expansion of currency, the inflationary potentiality of that financial arrangement is obvious. The incurring of expenditure by the British Government in India resulted in the creation of large money incomes in the country, while at the same time it caused the removal of the resources available for consumption at home. In short, while the supply of money was increased, the local demand for money was decreased by limiting the amount of goods available in the country which could meet the expanded volume of money. The inevitable result was the fall in the value of money.

But while increase in money supply was only the manifestation of excess demand, the fact that there was over-expansion of money cannot be disputed. There was even flight from currency to a small extent as indicated by the fact that by the middle of 1942, even when the war news was unfavourable, the tone of the Bombay Stock Exchange was quite strong. This suggests the strong preference for shares developed by the public as a safeguard against capital loss in the context of rapidly rising prices and growing scarcity of goods.<sup>2</sup> The fact also remains that the increased volume of money did not exert its full pressure on prices in so far as the velocity of circulation of bank deposits and most probably of currency notes as well, actually declined. This, however, had an ominous significance in as much as it constituted a potential source of run-away inflation if at any time the confidence of the public in the financial stability of the State was impaired.

Besides monetary expansion, there were other causes at work which pushed up prices during this period. The speculative rise of the first few months of war had given place to a set of persistent and more powerful factors stemming from the abnormal conditions brought on by war. The rise since the middle of 1940 was chiefly due to increased war demand as against restricted supply, increased cost of imported materials required for local manufactures, improved purchasing power of certain classes, progressive increase in govern-

<sup>1</sup> Government of India, Finance Department, *Budget*, 1943-44.

<sup>2</sup> League of Nations, *World Economic Survey*, 1939-41, p. 111.



ment expenditure, transport difficulties and certain purely local causes in some cases. By the middle of 1941, there was a sharp rise in the prices of many of the consumption goods at important centres like Bombay, Calcutta and Madras. The spectacular rise in piece-goods prices was due to the elimination of Japanese competition, fall of imports from Britain and increased export demand for Indian products. The flare up in the Far East in December 1941, and the failure of the various annual price control conferences to do something effective to hold down prices account for the sudden spurt in 1942. Last but not least, speculation at this time once again showed its head. Speculative cornering became quite rife in the markets for food items, such as wheat, rice and tea. It gathered strength with the increasing strain of military orders for goods on the nation's economy and manifested itself in every channel of trade.

In a study of war-time price trends, the period of three years from the middle of 1940 to the middle of 1943 has a special significance in so far as 98 per cent of the price rise, since August 1940 till the end of war, had taken place during this period. A review of the broad features of the rise in price during this period will not therefore, be out of place here.

It should be mentioned at the outset that the general index indicates only very broadly the pattern of price movements in a country. It hides the extent to which the price movements of various groups diverge from one another and sometimes take quite opposite courses. Such disparities are not surprising in normal times and quite common in the peculiar circumstances brought on by war. The explanation for this phenomenon is to be found in the fact that the nature of demand varies with changes in the pattern of income distribution, that the supply of some articles is more elastic than that of others, that there are considerable variations in the degree of competition in the markets for different articles and that in the case of some articles there is an element of price rigidity owing to the interference by the State, monopolistic practices or the influence of custom. It is thus clear that for a proper understanding of the movement of general indices, a correlation of the price movements of the different groups of articles on which the general index is based is necessary.

A glance on the graph on p. 28 would show that the general index rose only slightly between August 1940 and May 1941, but registered a sharp increase between April 1942 and June 1943. The relatively slight rise in the first period was due to two nearly opposite

pulls on the general index. Throughout this period the prices of manufactured articles and industrial raw materials remained much higher than the prices of other groups. On the other hand, the prices of food articles and primary commodities on the whole remained low. It may also be observed that although general index gained only 13.1 points between August 1940 and May 1941, yet it was subject to considerable fluctuations, especially in 1941, as shown in Table 3.

TABLE 3  
GENERAL INDEX NUMBERS OF WHOLESALE PRICES, 1941  
(Economic Adviser's Index)

|          |       |
|----------|-------|
| January  | 114.8 |
| February | 111.1 |
| March    | 118.8 |
| April    | 116.4 |
| May      | 121.5 |
| June     | 130.2 |
| July     | 140.9 |
| August   | 142.5 |

(Source: *Monthly Survey of Business Conditions in India.*)

This fluctuation is only a reflection of the much wider fluctuations of agricultural commodities, raw materials and food articles. Of these the first shows the greatest unsteadiness. The variation of this group ranged from 94.5 in February 1941 to 152.7 in August of the same year. The indices of food articles and raw materials were also fluctuating in a comparatively wide range.

The steep rise in the general index, in the four-month period May to August 1941, is quite typical of the movements of prices of all groups. However, in this short period the rate of increase in the prices of agricultural commodities, food articles and primary commodities (49 per cent, 24 per cent and 23 per cent respectively) was higher than the rate of increase in manufactured goods (22 per cent), and industrial raw materials (14 per cent). Between April 1942 and July 1943, all groups showed a marked rise, but manufactured articles, agricultural commodities, and food articles moved up more rapidly than industrial raw materials and primary commodities. The steep rise of manufactured articles was obviously



due to the virtual stoppage of imports consequent upon the extension of the war. The fall of Burma was immediately reflected in the movement of the price index of rice. From 218 in February 1943 it jumped to 496 in the next month and touched 1,034 in August 1943.

(c) *Period of Relative Stability* (June 1943 to August 1945)

The last phase in the price movement during the war period, from the middle of 1943 to the end of the war in 1945, is characterized by a great degree of stability in prices although this stability was maintained at a high level. Between June 1943 and August 1945, the general index gained only 2.4 points as against its rise by 116.7 points in the preceding corresponding period of 27 months, i.e. from April 1941 to June 1943. Of the total increase of 135.7 points over the entire war period since the middle of 1940, 1.8 per cent of the rise took place in the 26 months period between June 1943 and August 1945 and as much as 70 per cent of the rise occurred in the 14 months period between April 1942 and June 1943. The following quarter-end figures illustrate the satisfactory price position attained in the country during the last two years of war.

TABLE 4  
PRICE INDICES: QUARTER END FIGURES

|         |     | <i>All primary<br/>commodities</i> | <i>Manufactured<br/>articles</i> | <i>General<br/>Index</i> | <i>Bombay cost<br/>of living</i> |
|---------|-----|------------------------------------|----------------------------------|--------------------------|----------------------------------|
| 1943-44 | I   | 238.8                              | 263.5                            | 244.0                    | 235                              |
|         | II  | 237.5                              | 252.3                            | 240.6                    | 245                              |
|         | III | 232.2                              | 251.6                            | 236.3                    | 247                              |
|         | IV  | 231.8                              | 259.8                            | 237.6                    | 223                              |
| 1944-45 | I   | 240.1                              | 260.1                            | 244.3                    | 236                              |
|         | II  | 238.5                              | 258.1                            | 242.6                    | 239                              |
|         | III | 247.8                              | 257.8                            | 250.0                    | 236                              |
|         | IV  | 246.8                              | 252.8                            | 248.1                    | 225                              |
| 1945-46 | I   | 240.3                              | 244.7                            | 241.3                    | 235                              |
|         | II  | 243.8                              | 243.1                            | 243.6                    | 240                              |
|         | III | 251.6                              | 235.2                            | 247.9                    | 242                              |
|         | IV  | 257.4                              | 242.8                            | 254.2                    | 247                              |

(Source: *Report on Currency and Finance, 1945-56, p. 14.*)

It may be seen from the above table that the general index touched the lowest point (236) in this period in the last quarter of 1943, and since then it fluctuated between 240 and 250, and in the third quarter of 1945 stood at 243.6. While primary commodities reached the lowest point, 231.8, in the first quarter of 1944 and thereafter tended slowly to rise with some oscillations, manufactured articles show a reverse trend. In 1943 there is a steady decline in this group, a rise in the first half of 1944 and thereafter again a downtrend reaching the low level of 235.2 in the last quarter of 1945.

The effect of price stability attained in the last two years of war is reflected on the cost of living indices. The range of variation in the wholesale prices in 1944 was 11.2 points, while it was as high as 51.3 in the previous year. This stability, combined with the introduction of food rationing in the urban centres and the close supervision exercised by the Central and Provincial Governments in the matter of procurement and distribution of food articles, maintained the food index at a relatively low level. The cost of living indices and the retail price index numbers, by groups, of different centres in the country prepared by the Labour Department of the Government of India, show clearly that prices of most of the necessary articles of consumption, such as food and clothing, were kept within bounds during this period. This satisfactory price position at the end of the war period was in a large measure due to the effective control measures adopted by the government.

#### *A Comparison with Other Countries*

An interesting feature of the price trends in the last stages of the war is the great degree of uniformity in several countries. Price stability, between the middle of 1943 and the end of the war in 1945, is not a feature peculiar to India, but common to most countries of the world which have attained different standards of economic and political development. It is true of countries actively engaged in war as well as of those neutral countries which escaped the direct consequences of a shooting war. It applies to predominantly agricultural countries like India and Argentina as well as to highly industrialized and developed countries. Table 5 shows that in all these countries the tendency of prices was to stabilize as the war was drawing to its close.

TABLE 5

WHOLESALE PRICES: PERCENTAGE INCREASE (+) OR DECREASE (-) IN EACH OF THE CALENDAR YEARS

| Countries      | 1940 | 1941 | 1942 | 1943 | 1944 |
|----------------|------|------|------|------|------|
| Canada         | + 3  | + 11 | + 3  | + 6  | 0    |
| Sweden         | + 21 | + 12 | + 9  | 0    | 0    |
| Switzerland    | + 31 | + 21 | + 8  | + 2  | 0    |
| India          | - 15 | + 29 | + 54 | + 27 | 0    |
| U.S.A.         | + 1  | + 17 | + 7  | + 2  | + 1  |
| Australia      | + 12 | + 5  | + 12 | + 1  | + 1  |
| New Zealand    | + 13 | + 9  | + 7  | + 6  | + 1  |
| United Kingdom | + 21 | + 5  | + 4  | + 1  | + 2  |
| Germany        | + 3  | + 2  | + 2  | + 1  | + 2  |
| Denmark        | + 34 | + 10 | + 2  | + 1  | + 2  |
| Palestine      | + 25 | + 46 | + 34 | + 13 | + 3  |
| Argentina      | 0    | + 39 | + 13 | + 6  | + 6  |
| Spain          | + 17 | + 19 | + 12 | + 7  | + 8  |
| Portugal       | + 23 | + 10 | + 19 | + 22 | + 9  |
| Egypt          | + 15 | + 29 | + 38 | + 17 | + 13 |
| Japan          | 0    | + 11 | + 3  | + 9  | + 14 |

(Source: *Eastern Economist*, 17th August 1945, p. 236.)

It may be observed that of the sixteen countries listed above, only in six was the rate of increase in wholesale prices in 1944 greater than in the preceding year and only in one, Japan, was the rate of increase in 1944 higher than in 1942.

The similarity in the price trends in various countries is, however, observable only in the closing stages of the war. It was quite inevitable that the huge expenditure incurred by all the leading countries of the world for military purposes and the concentration of their productive power on the waging of the war, should have serious repercussions on the economy of the neutral countries as well. The inflationary situation in most of the countries during the war and subsequent to it, whether they were actively engaged in fighting or not, is therefore not surprising. But, though the rise of commodity prices was common all the world over, yet, there was considerable variation in the degree and in the timing of the advances, depending on the extent of self-sufficiency, inflationary pressure, the efficiency of control, etc. in various countries.

The following classification based on the degree of price rise gives an idea of the relative position of different countries in this respect.<sup>1</sup>

1. Less than 50 per cent rise in the wholesale prices during the war. . . U.S.A., Australia, Canada, Germany.
2. 50 to 100 per cent rise . . . United Kingdom, Japan, Norway, Sweden, Belgium, Netherlands, Mexico.
3. 100 to 250 per cent rise . . . Spain, Switzerland, Portugal, Argentina, Chile, Peru.
4. More than 250 per cent rise, . . . India, Middle East Countries.
5. Runaway inflation . . . China, Greece.

This disparity in price movements cannot be explained by the extent to which currency was expanded in these countries. The figures in Table 6 show clearly that there was no correlation between the degree of currency expansion and the degree of rise in the price level. It is seen that in Canada, the U.S.A. and Australia the increase in currency note circulation was the greatest, while rise in prices was the lowest. On the other hand, in Spain and Switzerland currency expansion was not significant, but the rise in prices was quite high. In India alone there is a correspondence between the degree of increase in note circulation and price level.

Nor is there any close relationship between inflation and active participation in war. Thus, the price rise in Germany, the United Kingdom and the U.S.A. was very much lower than in many neutral countries in Europe as well as in the Middle East. In general, the following observations can be made. In the first place, the degree of inflation was low in those countries which have a good and efficient administrative mechanism and which have attained to a high standard of economic development. Thus, in the U.S.A., the U.K. and Canada, the general wholesale price level between 1939 and 1945 rose by 38 per cent, 64 per cent and 39 per cent while cost of living in the same period rose by 28 per cent, 29 per cent and 19 per cent respectively. On the other hand, in India general price level went up by 99 per cent and cost of

<sup>1</sup> *Eastern Economist*, 7th September 1945, p. 347.



TABLE 6

## NOTES IN CIRCULATION

(In millions of the National Currency units)

| Country        | 1939   | End of 1945 | Index<br>Numbers of<br>notes in<br>circulation<br>(1939 = 100) | Grouping<br>according to<br>degree of<br>currency<br>expansion |
|----------------|--------|-------------|--|--|
| Japan          | 3818   | 28456       | 745  | More than<br>250%  |
| India          | 2245   | 12109       | 539  |  |
| Canada         | 233    | 1129        | 484  |  |
| France         | 151322 | 570006      | 377  |  |
| U.S.A.         | 7598   | 28507       | 375  |  |
| Australia      | 57     | 200         | 351  |  |
| Portugal       | 2494   | 7847        | 315  | 100 to 250%  |
| Turkey         | 281    | 880         | 313  |  |
| Chile          | 950    | 2657        | 280  |  |
| Norway         | 575    | 1478        | 257  |  |
| Belgium        | 27994  | 70376       | 251  |  |
| United Kingdom | 555    | 1380        | 249  |  |
| Argentina      | 1191   | 2722        | 228  | 50 to 100%   |
| Sweden         | 1422   | 2782        | 196  |  |
| Switzerland    | 2050   | 3835        | 187  |  |
| Spain          | 10690  | 17947       | 168  |  |
| Netherlands    | 1152   | 1713        | 149  | Less than 50%  |

(Source: *Commerce*, 1st June 1946, p. 970.)

living by 117 per cent.<sup>1</sup> In all these countries, the greater part of the increase in price level had taken place before the end of 1941. Since the beginning of 1942, the increase was quite slow and gradual. Thus, in the U.K., between August 1939 and December 1941, the general index gained 58 points, while between January 1942 and December 1945 it increased by only 14 points. Similarly, in the U.S.A. in the first period, the increase was 19 points and in the second period 11 points. The corresponding figures for Canada are 22 and 10. The extent to which an efficient administrative mechanism in combination with a high degree of civic

<sup>1</sup> Bombay Cost of Living Index, from 105 to 228.



sense can help in keeping prices within control is illustrated by the working of control methods in the United Kingdom. In so far as no restriction was placed on increase in wages and salaries, and farmers had to be offered an incentive in the form of higher wages in order to ensure increased agricultural production, there was every chance of a wage price spiral in that country. Nevertheless the index number of retail food prices in the U.K. increased between 1939 and 1945 only by 21 per cent and the cost of living by 29 per cent. This end was achieved by three methods—direct control of prices, transfer to the government of a good proportion of the business incomes of the community by taxation, and encouragement of savings.

Another fact that can be noted in the war-time price trends is that in those countries where control measures were adopted sufficiently early, prices remained comparatively low and steady. Thus, in the United Kingdom control of the prices of basic materials had become fairly effective in 1941. In Germany cost of living and food prices were pegged at a low level of 112 (January to June 1939 = 100) soon after the war started, and the prices remained remarkably stable. In Australia price control was introduced on the very first day of the war. In all these countries prices were kept within control throughout the war period. Early start by itself alone could not have been responsible for the effectiveness of control; but, that it helped in the forging of a strong control mechanism as the war progressed and thereby prevented prices going the way they did in some other countries cannot be disputed.

Leaving out of account China and Greece where runaway inflationary conditions prevailed, those countries which experienced the highest increase in the price level during the war period were India and the Middle East countries. Besides being economically under-developed, they were labouring under certain peculiar difficulties during war which proved a serious obstacle to effective control of prices. Although these countries did not become theatres of war, they had foreign armies quartered in them as a result of which they experienced great increases in demand in the face of severe shortage of imported supplies. In so far as they had not the efficient administrative mechanism which would assist in the absorption of excess purchasing power from the community by way of taxation or increased savings, these countries suffered serious price inflations. By the middle of 1944, cost of living had increased

from the 1939 level by 258 per cent in Iraq, 342 per cent in Turkey, 407 per cent in Lebanon and 746 per cent in Iran. During the same period and for nearly similar reasons, prices in India more than doubled.<sup>1</sup>

<sup>1</sup> A. J. Brown, *Applied Economics*, 1949, p. 106.

## CHAPTER III

### POST-WAR PRICE TRENDS

AT THE close of the war in August 1945, the forces of inflation and deflation appeared evenly matched in this country. The certainty of a marked decrease in public expenditure with the return of peace, the possibility of a fall in employment level and in purchasing power consequent upon demobilization and the chances of larger stocks of goods becoming available for the consumers seemed to be factors working on the side of deflation. On the other hand, relaxation or abolition of controls when war ended, the pressure of pent-up consumer's demand, the easing of the tax burden, the return of hoarded currency into circulation and above all the psychological factor after the end of the war, making the people feel themselves ~~to be~~ in a position to enjoy a normal and comfortable life would, it was supposed, work in the opposite direction. Although it appeared in the early part of 1945 that these opposing tendencies would work themselves out after the close of the war and as a result prices would neither rise nor fall in the immediate post-war period, yet, it was realized by the informed public in the country that not long after there would be the inevitable downtrend in prices following the war boom.

As against these anticipations, prices in the post-war period continued to rise and touched the peak level of 457.5 points in April 1951. Thus, between August 1945 and April 1951, the Economic Adviser's General Index of Wholesale Prices gained 213.4 points as against 144.1 points in the entire war period. Not only has the total increase been greater since mid 1945, but the range of fluctuations in prices has also been wider. The highest range of fluctuation for any twelve month period in war-time was between July 1942 and June 1943 when the index number moved up from 159.9 points to 241.7 points—a difference of 81.8 points. On the other hand, in the post-war period the range was 88.2 points between August 1947 and July 1948 and 89.2 points between June 1951 and May 1952 when the index number sharply receded from 456.3 to 367.1.

A series of factors has conspired to push up prices since 1945. Immediately after the end of hostilities in Europe in May 1945, there was a slight downtrend in price level mostly due to the psychological factor associated with the thought that even as war was responsible

for rise in the price level, its end should logically bring down prices. This gave place to an upward movement which continued from June 1945 till the second quarter of 1951. The general rise in the price level during this period of about six years was helped by three distinct inflationary factors. The rise, soon after the end of war, was due to the relaxation or abolition of several controls, which brought into play the inflationary pressure of the pent up consumer's demand. This uptrend which gathered momentum towards the close of 1947 after partition of the country, continued till July 1948 when as a result of the reimposition of controls, the rapid rise in the price level was held down and prices were maintained at a stable level for a period of fourteen months. The second loop in the price level commenced from the beginning of the last quarter of 1949 following devaluation of the rupee on 19th September 1949. However, the rise consequent upon devaluation was neither very great nor long lived. The much faster rate at which prices went up in the third phase of the period—mid 1950 to April 1951—was due to an altogether external factor, namely, outbreak of war in Korea. This fairly long period of rising prices, from mid 1945 to 1951, was followed by a period of recession which started at about the middle of 1951 and touched the lowest level in May 1952, when the general index number of wholesale prices slipped back to a point even lower than it was just before devaluation. The third period, commencing from May 1952 and synchronizing with the inauguration of the era of planned economic development, started with a recovery of prices, the recovery and the rise being due mainly to the large spendings of the government on development schemes. In the latter years of this period, there has been a considerable rise in price level. The first three phases of the price trends since 1945, viz. rising prices up to 1951 and recession and recovery since the second quarter of 1951 to about the close of 1953 are illustrated in Chart II.

A detailed discussion of the forces at work behind these different phases in the price movements in India in the last fifteen years may now be attempted.

#### *Rising Trend: August 1945 to April 1951*

##### *(a) Decontrol and After*

Immediately after the end of hostilities in Europe price position



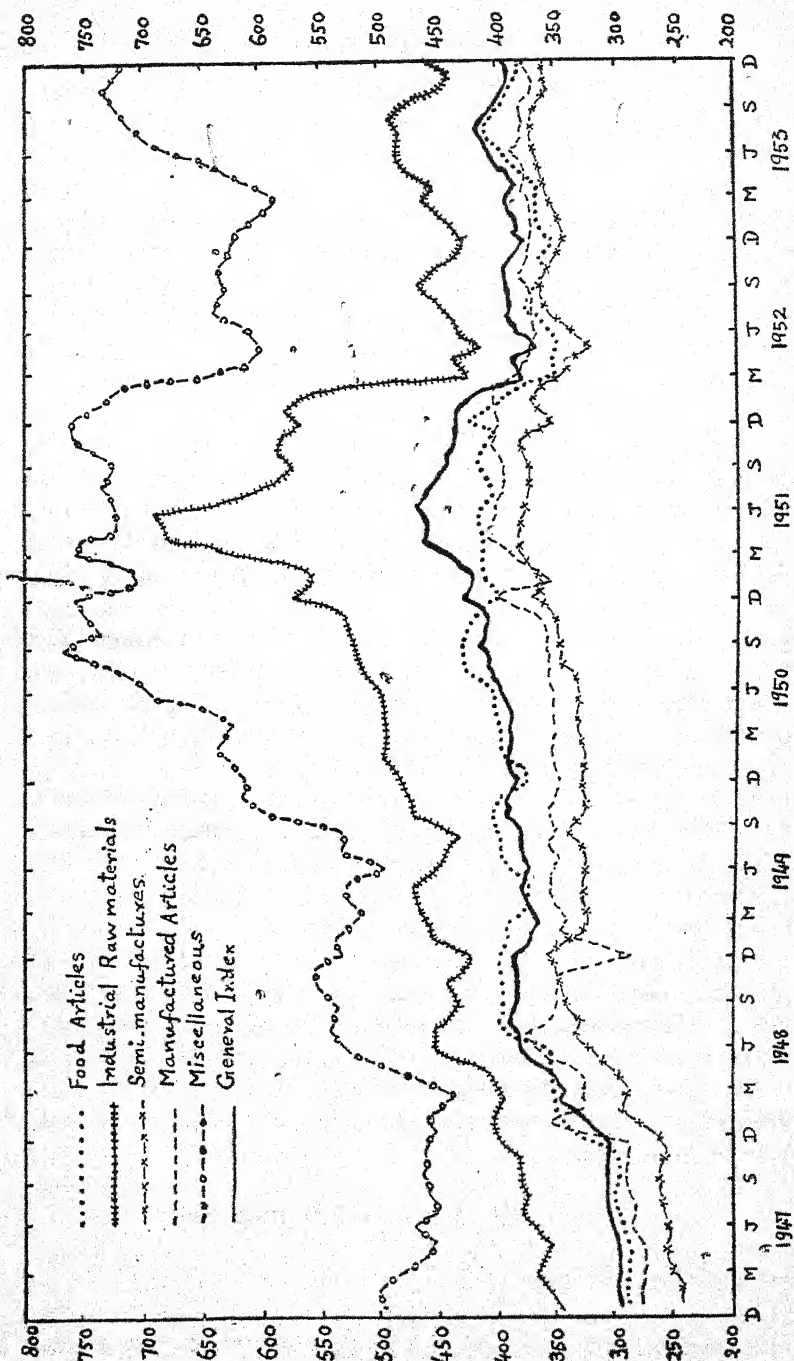


Chart II: Index Numbers of Wholesale Prices, 1947-53 (Base: Year ended August 1939=100).



in most of the countries of the world improved. In the United Kingdom, the U.S.A. and Canada prices reached a high level in July 1945 and thereafter declined. As in the West, in India also there was a favourable turn. This, however, cannot exclusively be attributed to the end of fighting. It was in fact the continuation of a persistent trend that commenced from the beginning of 1945. Between January 1945 and June of the same year, the general index fell from 250.3 to 237.4, i.e. by nearly 13 points in six months time. As has been observed in the preceding section the upward thrust had been arrested by the middle of 1943, and since then the annual rate of increase in the general price level declined. Thus, while prices rose by 38 per cent in 1943-44, the rate of increase came down to 3 per cent in 1944-45 and to 0.8 per cent in 1945-46.

This downtrend, however, proved to be very temporary. From the middle of 1945 the upward movement of the price level continued. This was against the hopes entertained when the war was drawing to its close. But in this India was not a lone sufferer. There were obvious signs of inflation in the U.S.A., the United Kingdom, France and other countries. In Hungary and Greece the position became really serious so as to threaten a return of the experience of Germany after the close of the First World War. The causes of this rise varied from country to country. In the U.S.A. cheap money policy, expansion of bank credit and the removal of controls were responsible for the mounting up of the general index from 106 in mid-1945 to 169 in the third quarter of 1948. In Britain increase in money supply, expansion of bank deposits, the slackening in the savings movement (which was the cornerstone of the price control structure in that country), the inauguration of the policy of increasing exports and restricting imports, all these helped to push up prices. In France there was a sharp increase in money supply. In Canada pressing demand, widely distributed stocks of money, shortage of raw materials and factors of production and decontrol accounted for the rise. In Italy it was budgetary deficits and political instability.

So far as India is concerned, the uptrend was due to the fact that many of the results which were expected to follow the return of peace and on which reliance was placed for a fall in prices did not materialize. The decline of the defence expenditure of the Government of India, the availability of about Rs. 90 crores worth of surplus for disposal, the fall in the Reserve Bank's foreign assets,

the comparative overvalued position of the rupee, import surpluses<sup>1</sup> and the further fall in the velocity of money should all have served as deflationary factors. In reality they did not operate as such because the inflationary factors were too strong for them. It is surprising to note that in the comparatively short period of three years, middle of 1945 to middle of 1948, many factors which can normally generate an inflationary situation and any one of which would be sufficient to cause a rise in the price level were functioning co-operatively and in full force.

Among the factors which were expected to have a deflationary effect in the immediate post-war period, but which did not actually come about, may be mentioned the following. In the first place, the end of war did not immediately bring about a fall in the level of employment to any notable extent and it did not affect the income or purchasing power of vast sections of the community. In the ~~years~~ 1945 and 1946 more than 13 lakh men were released, but in 1947 the rate of demobilization slackened considerably and even of the men who were demobilized a good number were reabsorbed in some other employment through the Employment Exchanges. As regards workers employed in the factories, their number declined only slightly—from the average daily number of 2.44 millions in 1945 to 2.23 millions in 1947, i.e. by 9 per cent only. As against this slight decline in the number of men employed, the total earnings of this section of the community which have a direct effect on the price trends actually increased. This was due to the improvement in the average earnings of the employees consequent upon the enhancement of wages and allowances on the basis of the recommendations of the Central and Provincial Pay Commissions<sup>2</sup> and similar additions to wages and allowances granted by private employers. As a result of these concessions the average annual earnings of employees in factories in 1947 recorded an increase of about 24 per cent over those in 1945. Apart from this increased purchasing power, an important factor which tended to push up prices was the shift in income towards the spending sector of the population. The National Income studies of the *Eastern Economist*

<sup>1</sup> Import surpluses amounted to Rs. 37.58 crores in 1947-48 and Rs. 95.18 crores in 1948-49.

<sup>2</sup> The Central Pay Commission constituted in May 1946 under the Chairmanship of Sir S. Varadachariar submitted its report in 1947, recommending more liberal Dearness Allowance to the government staff and also extensive reorganization of the pay scales.

have shown that the share of the primary sectors in the national income improved from 52.5 per cent in 1945-46 to 57.3 per cent in 1946-47 and 54 per cent in 1947-48, while the percentage share of labour in the industrial output increased from 20 in 1942-43 to 28 in 1944-45, 32 in 1945-46, 38 in 1946-47 and 34 in 1947-48. This trend indicates that actual spendable income in the country had increased.<sup>1</sup>

Secondly, although the rupee was overvalued, it did not help in holding down prices. It is true that during a short period following the end of war India had import surpluses. Nevertheless, the demand for Indian raw materials in foreign markets remained as high as before. Against all expectations, economic conditions in several countries of the world failed to improve when hostilities ceased. On the other hand, adverse seasonal conditions brought about shortages in the supply of many commodities. It is not surprising, therefore, that the external demand for Indian raw materials (as for example, Indian short staple cotton) was unexpectedly buoyant during the post-war period. Lastly, external price situation was not favourable for an easing of the inflationary pressure in our economy. When immediately after the war the U.S.A. removed controls, prices there went up sharply, the index of wholesale prices increasing from 123 in 1945 to 176 in 1947; and so important is the position of the U.S.A. in the economy of the world and so much is her influence on business conditions outside, that prices rose all over the world, India forming no exception.

Basically, a fall in the value of money should be explained in terms of the supply of currency and the demand for it as represented mainly by the output of goods. Between the end of March 1947 and March 1948, the total money supply with the public increased by Rs. 106 crores as against an increase of Rs. 18 crores in the preceding year. Simultaneously, during the two years 1945-46 and 1946-47, government pursued a cheap money policy and continued to float loans on progressively more favourable terms either by a reduction in the rate of interest on loans or by an increase in their maturity, which meant a lowering of the effective rate of interest.<sup>2</sup> In tune with this policy was the conversion of the 3½ per cent non-terminable loans into the 3 per cent Loan 1986 or the 2¾ per cent Loan 1976. The inflationary effect of this monetary

<sup>1</sup> *Eastern Economist*, 29th July 1949, p. 166.

<sup>2</sup> *Report on Currency and Finance*, 1945-46, p. 68.

policy was largely strengthened by government's budgetary policy. The deficit of the Central Government's budget on revenue account in the two years 1946-47 and 1947-48<sup>1</sup> was Rs. 51.81 crores and on capital account Rs. 194.93 crores. Setting off against this the provincial surplus of Rs. 17.29 crores during this period the net aggregate deficit amounted to Rs. 229.45 crores. This represents the difference between the amount absorbed from the people by the State by its tax policy and the amount put into their hands by its spending policy and indicates the extent to which purchasing power of the community was increased.

Against an increase in the supply of money and the purchasing power of the people, the output of goods, both agricultural and industrial, declined. The extent of fall in production is shown in Table 7.

TABLE 7  
VARIATION IN THE PRODUCTION OF ESSENTIAL COMMODITIES

| Commodities                          | 1945  | 1948  |
|--------------------------------------|-------|-------|
| Foodgrains (in thousand tons)        | 46093 | 44393 |
| Finished steel (in thousand tons)    | 954   | 854   |
| Cotton piecegoods (in million yards) | 4711  | 4319  |
| Jute manufactures (in thousand tons) | 1086  | 1091  |
| Cement (in thousand tons)            | 2209  | 1553  |

(Source: *Report on Currency and Finance*, 1949-50, pp. 148-50.)

While fall in agricultural output and deterioration in the food situation especially in 1945-46 were due to adverse seasonal conditions, the decline in industrial production is accounted for, partly at least, by labour discontent in the country exhibiting itself in strikes and disputes. In the first five months of 1947, industrial disputes numbered 152 against 138 and 34 in the corresponding periods of 1946 and 1939. At the same time the supply from outside was restricted. In the interests of conserving foreign exchange and checking non-essential imports, restrictions on imports were reimposed in March 1947. The Universal Open General Licence

<sup>1</sup> 7½ months in 1947-48 (from 15th August 1947 to 31st March 1948).

Source: *Report on Currency and Finance*, 1949-50, pp. 182-83.



No. VIII was cancelled and in May 1947 Open General Licences Numbers I and III were abolished.

Thus the stage was set for another spurt in price level before the decontrol policy of the government unleashed the fury of a half suppressed inflation. Between August 1945 and November 1947, when decontrol policy was implemented, the general index number rose from 244.1 to 302.0, a gain of 57.9 points in 26 months. Since November 1947 prices mounted up fast and the general index touched 389.6 points in July 1948, which means a rise of 87.6 points in 8 months time. In reversing the policy of control, government was actuated by the hope that hoarded stocks would come out and with that prices would recede. This, however, was too optimistic a view not justified by production figures of the time. Hoarded stocks amounted to little in relation to the need for commodities in the country so that what decontrol actually achieved was to make manifest an inflationary situation which hitherto lay partially camouflaged in a controlled economy. The removal of controls developed a "sudden and simultaneous rush to purchase the decontrolled goods with a consequent spurt in currency circulation".<sup>1</sup> The effect is seen in the nature of the movement of the price indices. While in 1947 the general index was fairly stable, in the next year it climbed up rapidly, gaining 15 points in January and nearly 20 points in May.

The rise in prices following decontrol caused considerable discontent in the country and government policy came in for trenchant criticism during the Assembly Debates in the middle of 1948. Government had now decided upon taking steps to arrest the runaway tendency of prices in the country. Before the last quarter of 1948 government had consulted the economists, industrialists and labour representatives of the country on the question of price control and had come to a decision with regard to the adoption of comprehensive measures to keep down prices. Apart from steps taken to control the prices of particular items, such as reimposition of the control on cloth and the cut and control on the prices of foodgrains, pig iron and steel, the fixation of the price of sugar and the downward revision of cloth prices, the government scheme involved such varied measures as encouragement to production, liberalization of imports and restriction of exports, curtailment of purchasing power by intensifying the Small Savings Campaign

<sup>1</sup> Reserve Bank of India Monthly Bulletin, August 1948, p. 499.



and by limiting the dividends of companies, check on speculation through the prohibition of future trading in commodities, and reduction in government expenditure with a view to ensuring balanced budgets.

The effects of these measures were soon seen. During the first quarter of 1949, prices of all groups, excepting industrial raw materials, declined. The general index came down from the peak level of 389.6 in July 1948 to 370.2 in March 1949. Manufactured articles led the downward movement of prices and their index in March 1949 was lower by 41 points than that in July of the previous year and foodgrains declined by 14 points. Among manufactured articles a significant fall was registered under textiles and cotton yarn, while in the case of foodgrains larger supplies at the harvesting season accounted for the decline. As against these, the opposite movement of the prices of industrial raw materials was the continuation of the tendency which had set in at the close of 1947. The irregular supply of cotton and jute from Pakistan largely accounts for the rise under this category.

Other factors also contributed to the downtrend. Money supply remained on the whole constant; bank deposits declined. At least the revenue budgets of the Central and Provincial Governments came to be better balanced. Large deficits in the balance of payments and the slight hardening of long-term interest rates were additional deflationary factors. Furthermore, conditions in foreign countries tended to push down prices. With increased industrial production in all European countries and the U.S.A., inflationary pressures eased and symptoms of deflation appeared. During the year 1949 price level in the U.S.A. declined by 7 per cent and that in Iran, Switzerland and Belgium by 23.3 per cent, 7.7 per cent and 6.5 per cent respectively; Turkey and Canada registered a decline of 2.1 per cent each.<sup>1</sup>

#### (b) *Devaluation and Its Subdued Effects*

The beneficial effects of the control measures were, however, short-lived. From the peak level of 389.6 in July 1948 the general index came down gradually to 370.2 in March 1949. Since then it began to creep up and reached 389.0 in August. The largest single factor responsible for the subsequent rise to 393.3 in May

<sup>1</sup> *Report on Currency and Finance, 1949-50*, p. 6.

1950 was devaluation of the rupee on September 19, 1949. At the time the devaluation decision was taken there was the fear that such a step would lead to a further rise in the price level. And there was sufficient justification for such fears. The direct effect of devaluation would be to raise the price of imports from dollar areas by 44 per cent. The higher price in terms of rupees of machinery and capital equipment imported from America would add to the cost of production of manufactured goods in India. Furthermore, the concentration of demand on the soft currency areas, consequent upon the higher prices of goods available in hard currency areas, would push up the prices in the former group of countries as well. Lastly, encouragement to exports from India which would follow from the devaluation of the rupee would produce a relative scarcity of goods at home which would not fail to have an inflationary effect on prices.

Against these anticipations, the actual price rise which took place in India after September 1949 was quite moderate. In March 1950, the general index was above the predevaluation figure (389.0) by only 0.9 per cent; and the net increase in the general index during 1949-50 was just 6.6 per cent relatively to the level at the close of the preceding year. This moderate rise was due to the movement of the prices of the different groups in opposite directions. In general, export articles registered the largest increases, while the prices of food items and manufactured goods actually declined. In the first category would come commodities like oilseeds, manganese ore, goatskin, cashewnuts, spices, etc. The uptrend in this group was obviously due to the price advantage which these commodities came to acquire in the European markets over competitive supplies from the Western Hemisphere as well as to the improved terms of trade in the U.S.A. market. The effect of devaluation of the rupee on the prices of different groups of articles is shown in Table 8.

On the whole, therefore the post-devaluation rise in price level in India was less than it had been feared. And in this respect the price trends in India compare favourably with those in the United Kingdom. There in 1949 the retail price index went up by 4 per cent and the food index by as much as 11 per cent. In the first half of 1950 wholesale price index rose 9 per cent over the year 1949, the food item being responsible for a rise of no less than 19 per cent.

TABLE 8  
MOVEMENT IN PRICE INDICES SINCE DEVALUATION

| <i>Commodity groups</i>             | <i>August<br/>1949<br/>(1)</i> | <i>March<br/>1950<br/>(2)</i> | <i>Percentage<br/>increase or<br/>decrease of (2)<br/>over (1)</i> |
|-------------------------------------|--------------------------------|-------------------------------|--|
| <b>I. Food Articles</b>             | 410.6                          | 396.2                         | — 3.5  |
| Cereals                             | 474                            | 454                           | — 4.2  |
| Pulses                              | 461                            | 440                           | — 4.6  |
| Others                              | 309                            | 303                           | — 1.9  |
| <b>II. Industrial Raw Materials</b> | 460.5                          | 490.1                         | + 6.4  |
| Fibres                              | 423                            | 469                           | +10.9  |
| Oilseeds                            | 633                            | 642                           | + 1.4  |
| Minerals                            | 336                            | 337                           | + 0.3  |
| Others                              | 347                            | 366                           | + 5.5  |
| <b>III. Semi-manufactures</b>       | 330.8                          | 338.2                         | + 2.2  |
| Leather                             | 309                            | 361                           | +16.8  |
| Mineral oils                        | 183                            | 199                           | + 8.7  |
| Vegetable oils                      | 641                            | 678                           | + 5.8  |
| Cotton yarn                         | 435                            | 413                           | — 5.1  |
| Metals                              | 174                            | 172                           | — 1.1  |
| Oil cakes                           | 409                            | 424                           | + 3.7  |
| Others                              | 245                            | 290                           | +18.4  |
| <b>IV. Manufactured Articles</b>    | 348.6                          | 347.4                         | — 0.3  |
| Textiles                            | 403                            | 402                           | — 0.2  |
| Metal products                      | 272                            | 265                           | — 2.6  |
| Others                              | 267                            | 270                           | + 1.1  |
| <b>V. Miscellaneous</b>             | 541.6                          | 630.6                         | +16.4  |
| <b>VI. All Commodities</b>          | 389.0                          | 392.4                         | + 0.9  |

(Source: *Report on Currency and Finance, 1949-50*, p. 152.)

Even the moderate rise in the general level of prices in India subsequent to devaluation cannot be attributed exclusively to devaluation. It is worth noting that before the decision on devaluation was taken, prices in India, particularly those of the food group and manufactured articles, started to move up. The failure of the monsoon in 1949 and the diversion of a large acreage from food crops to non-food crops such as jute and cotton—a step taken by the government soon after Partition in order to make the country less dependent on Pakistan for these raw materials—resulted in a shortage of foodgrains which helped to raise the

prices of this group. The advance in the prices of manufactured articles was largely due to government's policy of restricting imports in order to prevent the yawning gap in the country's foreign trade position from becoming wider still. As a result, the indices of food articles went up from 379.1 in January 1950 to 426.5 in August and that of manufactured articles from 344.6 to 349.9 in the same period. The general index which stood at 384.7 in the beginning of the year touched 409.2 in September. Another point which has to be noted is that throughout 1950 and in the subsequent years other factors were at work which by themselves alone would have pushed up prices. Besides diminished imports and declining production at home, one important factor, other than devaluation, responsible for the rise in prices was the budgetary policy of the government. Increased capital expenditure and deficit budgets produced an inflationary potential in the two years 1948-49 and 1949-50 of the order of at least Rs. 176 crores. In fact, about the middle of 1950 it had begun to be realized that inflation in the country was no longer due to devaluation but due to the unsound budgetary policy of the Centre and the States.<sup>1</sup>

The inflationary effects of devaluation were limited and short-lived because of two reasons. Whatever be the controversy at the time when the rupee was devalued, it is now an accepted fact that devaluation in India was essentially a defensive measure designed solely for the purpose of safeguarding the country's foreign trade position. To a great extent it was forced upon the country by the pressure of circumstances. Devaluation did not raise prices very much, because already the prices in India were much higher than prices outside so that devaluation only recognized the *de facto* position. This is shown in the disparity in the index number of prices of internationally traded goods. Goods of this category in America stood at 175 in the last quarter of 1949 with 1937 as base; in the principal European countries it was 210. Corresponding figures for two Indian commodities which largely enter into international trade—jute fibre and jute manufactures—were 428 and 549 respectively. This is one explanation why Indian prices did not go up much consequent upon the reduction of the value of rupee in terms of U.S. dollar from 30.225 cents to 21 cents. Secondly, it cannot be denied that government measures of control had a considerable restraining effect on the inflationary power

<sup>1</sup> *Eastern Economist*, 21st July 1950, p. 84.



of devaluation. It has already been observed that in the few months preceding devaluation prices were maintained stable mostly because of government's control policy. Before the devaluation decision was made, government had anticipated a rise in the price level and had tightened its measures of control.

*(c) The Korean Boom*

From the point of view of its inflationary effect, devaluation appears to have lost its strength in the first quarter of 1950. The acceleration of the rate of increase in the general price level since the second quarter of that year was mostly due to external political factors. The outbreak of war in Korea, on the 25th June 1950, led to a feverish stockpiling programme in all important countries, the lead being taken by the U.S.A. The scramble for raw materials, which had already become scarce, resulted in a competitive pushing up of prices in the world markets. Particularly in the U.S.A., speculative cornering of goods in order to take advantage of the rise in prices and government's huge rearmament programmes, caused a sharp rise in prices in all the three major groups of commodities—industrial products, farm products as well as foods. The general index went up from 182 in June 1950 to the peak level of 203 in December. The uptrend in the general price level which started during the first quarter of 1950 gained further momentum in the last quarter of 1950 and in the first quarter of 1951. Between March 1950 and March 1951 prices rose in the U.S.A. by 20.3 per cent, in the United Kingdom by 27.4 per cent and in Australia by 29.5 per cent.

The position in the less developed countries was more serious. This was the natural consequence of prices of raw materials going up faster and higher than those of the other groups. Between April 1950 and March 1951, the price of rubber went up by 288 per cent, tin 211.9 per cent, sisal 186.9 per cent, cocoa 154.3 per cent and copper 124.7 per cent. The higher prices earned by the primary producing countries reacted upon their money supply and income level and produced serious inflationary conditions. The Economic Commission for Europe estimated, in May 1951, that if the prices of December 1950 were maintained on the average throughout 1951, in respect of twenty selected primary commodities, the income accruing to the primary producer in that year would be greater



by anything from \$3 billion to \$4 billion. In this sense America was in fact exporting inflation to this group of countries.

Between June 1950 and April 1951, acute shortages in industrial raw materials like jute and cotton and in capital and consumer goods, foodgrains and cloth developed in India. The restrictions placed by foreign governments on the export of industrial raw materials and inadequacy of shipping combined with a fall in the United States cotton production pushed up the prices of articles belonging to this group by over 40 per cent in India. The figures in Table 9 illustrate the effect of the Korean War and the rearmament programme in the West on the price structure in India.

TABLE 9  
MOVEMENT IN PRICE INDICES AFTER THE OUTBREAK OF  
WAR IN KOREA

(Base: August 1939 = 100)

| <i>Commodity groups</i>             | <i>June<br/>1950<br/>(1)</i> | <i>April<br/>1951<br/>(2)</i> | <i>Percentage of<br/>increase or<br/>decrease of<br/>(2) over (1)</i> |
|-------------------------------------|------------------------------|-------------------------------|---|
| I. <i>Food Articles</i>             | 402.8                        | 412.5                         | + 2.4   |
| Cereals                             | 456                          | 490                           | + 7.4   |
| Pulses                              | 409                          | 501                           | +22.5   |
| Others                              | 321                          | 289                           | -10.0   |
| II. <i>Industrial Raw Materials</i> | 490.7                        | 683.1                         | +39.2   |
| Fibres                              | 466                          | 749                           | +60.8   |
| Oilseeds                            | 652                          | 716                           | + 9.9   |
| Minerals                            | 339                          | 407                           | +20.1   |
| Others                              | 362                          | 588                           | +62.4   |
| III. <i>Semi-manufactures</i>       | 335.5                        | 387.8                         | +15.6   |
| Leather                             | 334                          | 531                           | +58.9   |
| Mineral oils                        | 190                          | 195                           | + 2.6   |
| Vegetable oils                      | 663                          | 724                           | + 9.2   |
| Cotton yarn                         | 409                          | 493                           | +20.5   |
| Metals                              | 175                          | 191                           | + 9.1   |
| Oil cakes                           | 468                          | 508                           | + 8.5   |
| Others                              | 315                          | 347                           | +10.1   |
| IV. <i>Manufactured Articles</i>    | 347.6                        | 411.7                         | +18.4   |
| Textiles                            | 399                          | 501                           | +25.6   |
| Metal products                      | 269                          | 278                           | + 3.3   |
| Others                              | 274                          | 302                           | +10.2   |
| V. <i>Miscellaneous</i>             | 692.0                        | 751.5                         | + 8.6   |
| VI. <i>All Commodities</i>          | 395.6                        | 457.5                         | +15.6   |

The effect of increased American demand for industrial raw materials on the general price structure in India is seen in the fact that between June 1950 and April 1951, when the general index touched the highest point so far, the prices of articles in the raw materials group went up by 39.2 per cent as against the rise of 2.4 per cent in the food group and 18.4 per cent in the manufactured articles group. Among individual items the highest increase (60.8 per cent), was registered by cotton and jute, with leather (58.9 per cent) following closely. The inflationary pressure of foreign demand was such that the series of control measures adopted by the Government of India had only a limited and temporary success. The general index number came down from 412.5 in September to 410.9 in November 1950, but hereafter it resumed its upward trend reaching 438.6 in March and 457.5 in April 1951. This was due to the prolongation of the war in Korea, enhanced demand for India's export commodities, shortage of goods in most of the countries of the world, rising import prices and the granting of higher prices by government to a number of controlled commodities like sugar, sugarcane, foodgrains, cotton textiles and rubber. Following the decontrol of the prices of raw jute and jute manufactures on the 9th March 1951—a step taken as a sequel to the Indo-Pakistan Trade Agreement—the prices of these articles went up sharply. Thus, between the first and the last week of March 1951, the index number of raw jute shot up from 479 to 1026 and that of jute manufactures from 561 to 1052.

The Korean boom thus represents the last lap in the upward movement of prices which continued from the end of war to the second quarter of 1951. In April of that year the general index number reached a peak point, 457.5, and remained at about that level for three months. The rate of increase during the first phase of the Korean war has a parallel only in the rate of increase following decontrol in 1947, being respectively 10.8 points and 10.1 points a month in the four-month periods January to April 1951 and November 1947 to February 1948. The factors leading to this rapid rise during these two periods, however, are widely different. In 1947-48 it was mostly internal circumstances that led to the spurt in prices, in the latter period it was mostly external factors. In many countries of the world the price rise, which became quite significant when war ended, became spectacular and disturbing since the outbreak of hostilities in Korea. Thus, in the inflationary

trend in prices in 1950-51 India was to a great extent only sharing the experience of other countries as well.

*The Recession and Recovery, 1951-53*

The year 1951 is important in the history of prices in India in recent times, in so far as it witnessed, for the first time since 1940, a major reversal of the general uptrend in prices. Although in this period of more than a decade the rate of increase in prices had been slowed down at different stages and the price level was even kept steady during brief intervals, there was no significant downturn of the general index number. The forces that brought about this situation, in the latter half of 1951 and in the first quarter of 1952, were, like those responsible for the preceding rise, mostly external. These factors can be summarized as follows: (1) favourable weather conditions and increased supply of several agricultural products, particularly cotton, in the world; (2) overstocking of certain commodities during the Korean flare-up produced a natural reaction when the expanded stocks of raw materials could not be absorbed by industry, and a decline in demand followed; (3) Korean peace move in mid-1951, the stretching out of the rearmament programme in the U.S.A. and the revision of the stockpiling practice in that country produced deflationary conditions in the world's commodity markets;<sup>1</sup> (4) provisions for the orderly sharing of scarce materials through the agency of the International Materials Conference had considerable psychological influence on buyers by the elimination of buying competition. As a result of the combination of these factors, prices of most of the industrial raw materials required in connection with the rearmaments programme receded in the U.S.A. and reacted on the structure of prices in other countries. The extent to which prices of some international commodities declined in the course of 1951 is shown in Table 10.

The figures in this table show that commodities which were in great demand in connection with the stockpiling programme in various countries, particularly in the U.S.A., were subject to the wildest

<sup>1</sup> Early in 1951, the Munitions Board in U.S.A. introduced a change in its buying practice. Instead of concentrating on immediate purchases it revised its contracts, spreading out delivery over one or two years. This arrangement released larger supplies for current use and had a depressing effect on the markets.

TABLE 10

## COMMODITY PRICES IN 1951

| <i>Commodities</i>            | <i>Eve of<br/>Korean war</i> | <i>1951 peak</i> | <i>End of<br/>July 1951</i> | <i>Percentage<br/>decline<br/>from peak</i> |
|-------------------------------|------------------------------|------------------|-----------------------------|---|
|                               | d. per lb.                   | d. per lb.       | d. per lb.                  |   |
| Cotton American U. K.         | 33 1/8                       | 53               | 42                          | 21  |
| New York spot                 | 29 1/2                       | 39 1/2           | 33                          | 17  |
| Wool 66's                     | 145                          | 323              | 176                         | 46  |
| Rubber spot                   | 22 3/4                       | 74               | 45                          | 39  |
| Hides                         | 22                           | 51               | 29                          | 42  |
| Cocoa, New York<br>spot accra | 27 5/8                       | 133              | 29 1/2                      | 10  |
|                               | £ per ton                    | £ per ton        | £ per ton                   |   |
| Jute                          | 118                          | 250              | 185                         | 26  |
| Sisal no. 1                   | 130                          | 250              | 245                         | 2   |
| Sisal no. 2                   | 85                           | 174 1/2          | 148                         | 15  |
| Tin                           | 591 1/4                      | 1615             | 895                         | 45  |
| Barley                        | 21                           | 38               | 32                          | 16  |
| Linseed oil, U. K. price      | 132                          | 180              | 180                         | —   |
|                               | Sh. per unit                 | Sh. per unit     | Sh. per unit                |   |
| Wolfram                       | 126/3                        | 672/6            | 530/0                       | 21  |

(Source: *Commerce*, 1st September 1951, p. 387.)

fluctuations. The recession in early 1951 affected specially those countries of the Sterling area which are producers of primary commodities like tin, rubber and wool. The downtrend continued mostly throughout 1952 in many countries. In the first half of 1952, in some of the European countries—Norway, Holland, Belgium and Denmark—a fall in industrial production was accompanied by a sharp rise in unemployment, which threatened to bring about a serious depression. Apart from the slackening in the stockpiling programme, internal factors, such as stricter credit controls, provisions for rectifying the deficits in the balance of payment position, import cuts in the United Kingdom and Australia and the adoption of positive deflationary policies in Denmark and Holland, account for the reversal of the price trend in a large group of countries.

In India the recession started a little later than in the Western countries, but this late start was more than offset by the higher rate of fall. From the maximum level of 457.5 in April 1951 the Economic Adviser's general index declined to 430.3 in January 1952 and came down to 377.5 in March 1952, i.e. a decline of 6.7 points a month. Over the year 1951-52 the general price level showed a decline of 15.9 per cent as against a rise of 15 per cent during 1950-51. The extent of fall under the different items is shown in Table 11.

TABLE 11  
MOVEMENT IN PRICE INDICES OF DIFFERENT GROUPS OF  
COMMODITIES

| Group of Commodity           | Pre-de-<br>valua-<br>tion<br>Sept. 17,<br>1949 | Pre-<br>Korean<br>June 24,<br>1950 | Jan. 26,<br>1952 | March<br>1952 | Percent-<br>age vari-<br>ation of<br>(4) over<br>(3) |
|------------------------------|--|------------------------------------|------------------|---------------|--|
|                              | (1)  | (2)                                | (3)              | (4)           |  |
| I. Food Articles             | 392.6  | 407.1                              | 392.3            | 335.2         | -14.6  |
| Cereals                      | 460  | 456                                | 464              | 438           | - 5.6  |
| Pulses                       | 409  | 429                                | 506              | 391           | -22.7  |
| Others                       | 293  | 327                                | 273              | 200           | -26.7  |
| II. Industrial Raw Materials | 470.1  | 494.2                              | 573.8            | 382.8         | -33.3  |
| Fibres                       | 437  | 468                                | 609              | 379           | -37.8  |
| Oilseeds                     | 644  | 657                                | 602              | 370           | -38.5  |
| Minerals                     | 331  | 342                                | 449              | 466           | + 3.8  |
| Others                       | 347  | 371                                | 422              | 360           | -14.7  |
| III. Semi-manufactures       | 334.4  | 335.5                              | 370.1            | 339.0         | - 8.4  |
| Leather                      | 315  | 335                                | 329              | 341           | + 3.6  |
| Mineral oils                 | 183  | 190                                | 218              | 218           | —  |
| Vegetable oils               | 662  | 663                                | 597              | 376           | -37.0  |
| Cotton yarn                  | 435  | 409                                | 495              | 498           | + 0.6  |
| Oil cakes                    | 421  | 467                                | 483              | 403           | -16.6  |
| Metals                       | 175  | 174                                | 206              | 201           | - 2.4  |
| Others                       | 256  | 315                                | 320              | 286           | -10.6  |
| IV. Manufactured Articles    | 350.0  | 346.9                              | 399.4            | 376.6         | - 5.7  |
| Textiles                     | 405  | 398                                | 468              | 424           | - 9.4  |
| Metal products               | 272  | 269                                | 298              | 311           | + 4.4  |
| Others                       | 268  | 273                                | 304              | 301           | - 1.0  |
| V. Miscellaneous             | 557.8  | 692.4                              | 734.5            | 610.8         | -16.8  |
| VI. All Commodities          | 386.7  | 397.1                              | 428.8            | 364.9         | -14.9  |

(Source: Report on Currency and Finance, 1952-53.)



In mid March 1952 the general index number of wholesale prices had fallen not only below the point reached before the outbreak of war in Korea but even below the pre-devaluation level.

While the rise in prices, following the outbreak of war in Korea, was less in India than in the other countries, the recession after the middle of 1951 was much more pronounced. Between June 1950 and April 1951 prices in India rose by 15.7 per cent as against 23.9 per cent in the United Kingdom, 20.6 per cent in Australia and 16.8 per cent in the U.S.A. But in the subsequent months up to March 1952, prices in India declined by 17.6 per cent as against 2.7 per cent in the U.S.A., and a rise of 4.8 per cent and 12.7 per cent respectively in the United Kingdom and Australia. This disparity in the rate of rise and fall in the general price level in the three countries, the United Kingdom, the U.S.A. and India, is further illustrated by the figures in Table 12.

TABLE 12  
INDEX NUMBERS OF WHOLESALE PRICES IN INDIA, THE U.S.A.  
AND THE U.K.

(Base: January-June 1950 = 100)

|                   | <i>India</i> | <i>U.S.A.</i> | <i>U.K.</i> |
|-------------------|--------------|---------------|-------------|
| 1950 January-June | 100          | 100           | 100         |
| 1950 3rd quarter  | 104          | 107           | 106         |
| 1950 4th quarter  | 105          | 111           | 116         |
| 1951 1st quarter  | 109          | 117           | 124         |
| 1951 2nd quarter  | 116          | 117           | 129         |
| 1951 3rd quarter  | 113          | 116           | 130         |
| 1951 4th quarter  | 112          | 116           | 133         |
| 1952 1st quarter  | 104          | 114           | 134         |
| 1952 2nd quarter  | 96           | 113           | 131         |
| 1952 3rd quarter  | 99           | 113           | 130         |
| 1952 4th quarter  | 98           | 112           | 131         |

(Source: *Reserve Bank of India Monthly Bulletin*, June 1953, p. 469.)

The downward price trend which set in by the middle of January 1951 in India was sharp and spectacular. It affected more seriously the bullion and stock markets and some export commodities, particularly oilseeds, pepper, jute, cloth and wool. Towards the

last week of February, the prices of gold and silver bullion began sagging under persistent offerings. In fact, the worst hit market was the bullion market where operators experienced increasing difficulties in paying banks margins for advances against the yellow and white metals and had to liquidate their holdings. Simultaneously, decline in external demand seriously affected the commodity markets in the country. The U.S.A. imported 24,159,380 lb. of pepper in 1951. It was the lowest import in six years and was lower than the 1950 import by nearly 9 million pounds. The effect of this decline in demand is reflected on the price of this commodity which came down from about Rs. 2,900 per candy on the 1st March 1952 to Rs. 2,600 in the course of a week and tended to decline further. According to the estimates compiled by the Commonwealth Economic Committee and the International Wool Study Group, world consumption of wool during 1951 had dwindled to 2,150 million pounds from 2,652 million pounds in the previous year. On the other hand, world production of wool in 1951-52 showed a slight increase over that of the previous year. The total production of 1951-52 taken along with the previous year's stock held by the different exporting countries was calculated to be 14.4 per cent in excess of the estimated world consumption of wool in 1951. The considerable fall in the demand for jute in the external markets forced down the price of this export commodity to one-third of what it was in the middle of 1951. The heavy reduction in the export duty on hessians in India from Rs. 1,500 to Rs. 750 per ton had little effect on exports. Similar was the fate of the demand for cocoanut and groundnut oil in foreign markets. Low external off-take brought about a collapse of the business in cotton in all important centres. The Indian markets were as dull and featureless as the markets at Alexandria and Karachi and had to be closed for a number of days. Speculation accelerated the downtrend. In the early months of 1952, large amounts of export goods, such as oilseeds, raw cotton, pepper, lemon grass oil and other agricultural cash crops had been hoarded by speculators in the godowns of the banks which had lent them money. The easing of the foreign markets caused some nervousness among the speculators. They were, however, harbouring the hope that the budget would bring some relief in the shape of reduction in export duty and abolition of the surcharge on income tax and super tax. The reductions in the export duty on hessians and the forecast of a large budget surplus strengthened

their hopes. Some speculative operators had, therefore, gone long in oilseeds and shares. When the relief did not come and the Finance Minister announced that there would not be any tax reduction in the near future, the markets were seized with a panic and a regular stampede for selling ensued, which resulted in the crumbling of prices and share values. Many speculators in commodities cancelled even some of their genuine commitments for purchase at the high rates which prevailed formerly and this led to a general crash in commodity prices.

Although the early signs of the crumbling of the price structure in the first quarter of 1952 were welcomed with a sigh of relief by the hard-pressed middle class consumers, yet, in actual fact, the consumers did not benefit from it. The recession was too short-lived and affected mostly export articles. The index number of wholesale prices declined to 364.9 by the middle of March, about 30 points lower than the pre-Korean level, but again rose to 376.5 at the end of the month. This quick recovery was mostly due to the timely and prompt measures taken by the government in order to avert a crisis. While wholesale prices and that mostly of export goods declined quite rapidly, retail prices began to show some signs of easing only towards the last lap of the recession. The prices of a large number of consumption goods did not come down at all with the result that the cost of living remained high and stable. The Bombay cost of living index stood at 315 points in January 1952. The lowest level to which it fell was 298 points in March 1952, but it rose again to 329 points in the next month. The average for the year 1951-52 was 314 against 302 in the previous year.

While the consumers did not benefit much, many producers were hit hard. In a period of about two months the jute trade lost over Rs. 50 crores, cotton about Rs. 21 crores, sugar Rs. 1½ crores besides huge amounts in bullion, oilseeds, spices and chemicals. The loss in securities, excluding government securities, was estimated at Rs. 100 crores. Export traders, such as dealers in textiles and cotton, wool, jute, hides and skins, were the worst sufferers. In textiles, the growing accumulation of large stocks of finished goods and raw cotton because of declining demand depressed their markets. Some of the silk manufacturers in Bombay closed down their mills and several textile manufacturers in Bombay, Ahmedabad and other centres decided upon reducing shifts and shortening the

working time. This pessimistic attitude on the part of the business classes threatened the emergence of depression conditions. Government realized the seriousness of the situation, and in response to the appeals of the business classes offered prompt help. The measures taken by the government comprised facilitation of exports, removal of internal restrictions on distribution and provision of easier credit facilities. Partly as a result of these measures and to a large extent assisted by developments in foreign countries where prices had begun to recover, the rapid decline in price level in India was arrested and the general index number began to move up in the second quarter of 1952 save for a temporary set back in May. Exports of jute manufactures, vegetable oils and raw cotton increased substantially. The loans made by the Reserve Bank against government securities and usance bills helped to relieve stringencies in the money market and assisted in the process of readjustment. By the end of June 1952 the general index of prices had risen to 381, a rise of over 4 per cent compared with the lowest level touched during March 1952.

The figures in Table 13 illustrate the extent to which prices recovered in the two years since mid March 1952.

Between March 1952 and March 1954 the general price index went up by about 8 per cent. It may be noted that Industrial Raw Materials, Miscellaneous items and Food Articles which recovered by 20.3 per cent, 12.4 per cent and 10.8 per cent respectively were largely responsible for the general rise in the price level during this period.

It is possible to make out certain distinct characteristics of this period of recession and recovery. While wholesale prices were tending rapidly downwards, retail prices remained comparatively stable and the cost of living remained high. Nor was there any decrease in production. In fact, towards the close of 1952 industrial production reached very high levels. The recession affected sales and profits more than production and cost of living. To the extent cost of living did not decline in any notable measure, cost of production remained high, so that with selling prices coming down, the profit margin of the business class was considerably narrowed.

Even as the recession affected most seriously articles coming under the raw materials group and other primary commodities, the recovery that set in in the second quarter of 1952 was marked by a rise in the prices of such articles like raw cotton, raw jute, raw wool,



TABLE 13 1  
MOVEMENT IN PRICE INDICES OF DIFFERENT GROUPS OF  
COMMODITIES

| <i>Group of Commodity</i>           | <i>Mid March<br/>1952 (1)</i> | <i>20th March<br/>1954 (2)</i> | <i>Percentage<br/>variation of<br/>(2) over (1)</i> |
|-------------------------------------|-------------------------------|--------------------------------|---|
| <b>I. Food Articles</b>             | 335.2                         | 371.3                          | +10.8   |
| Cereals                             | 438                           | 425                            | — 3.0   |
| Pulses                              | 391                           | 365                            | — 6.7   |
| Others                              | 200                           | 292                            | +46.0   |
| <b>II. Industrial Raw Materials</b> | 382.8                         | 459.8                          | +20.3   |
| Fibres                              | 372                           | 443                            | +16.9   |
| Oilseeds                            | 370                           | 514                            | +38.9   |
| Minerals                            | 466                           | 442                            | — 5.2   |
| Others                              | 360                           | 403                            | +11.9   |
| <b>III. Semi-manufactures</b>       | 339.0                         | 355.6                          | + 4.9   |
| Leather                             | 341                           | 388                            | +13.8   |
| Minerals oils                       | 218                           | 221                            | + 1.4   |
| Vegetable oils                      | 376                           | 477                            | +26.9   |
| Cotton yarn                         | 498                           | 447                            | —10.2   |
| Oil cakes                           | 403                           | 417                            | + 3.5   |
| Metals                              | 201                           | 238                            | +18.4   |
| Others                              | 286                           | 306                            | + 7.0   |
| <b>IV. Manufactured Articles</b>    | 376.6                         | 375.7                          | — 0.2   |
| Textiles                            | 424                           | 419                            | — 1.2   |
| Metal products                      | 311                           | 337                            | + 8.4   |
| Others                              | 301                           | 286                            | — 4.9   |
| <b>V. Miscellaneous</b>             | 610.8                         | 686.3                          | +12.4   |
| <b>VI. All Commodities</b>          | 364.9                         | 394.0                          | + 4.9   |

(Source: *Report on Currency and Finance, 1952-53.*)

cotton seed, vegetable oils, etc. To a large extent this change in the situation was due to the revival of demand, both internal and external, for most of the country's products, following the measures taken by government in the direction of a liberalization of exports and relaxation of domestic controls over commodities. Early in 1953, government controls on certain categories of iron and steel manufactures were given up and by the middle of that year the remaining price and distribution controls over cotton cloth and yarn



were removed. Furthermore, adverse balance of payments, which was operating as a deflationary force for several years, was rectified, since the middle of 1952, by means of drastic cuts in imports. However, the immediate cause for recovery was of a technical type in the sense that it represented a reaction against the preceding slump. There was the feeling in business circles that prices in the first quarter of 1952 had gone down a little too far, so that in the subsequent months there was again a revival of activity on the part of traders in replenishing their stocks.

The recovery in 1952-54 was partly due to the measures taken by government in order to encourage business activity and partly a reaction to the excesses of the preceding slump conditions. But the rise in prices in these two years was not steady. After touching the maximum of 410.4 in August 1953, the general price level receded a little subsequently. The first eight months of 1953 was a period of rapid rise in prices, the rate of increase acquiring considerable momentum in the second quarter of the year. This rise was due to the general optimistic conditions prevailing among business classes and the consequent revival of confidence in the markets. The successful operation of the programmes in the Five Year Plan, the hopes of a reduction in the incidence of taxation as a result of the findings of the Taxation Enquiry Commission, and the favourable gesture shown by government in the form of relaxation of controls of foreign trade and minor concessions like reductions of duties on exports of manufactured articles and imports of essential raw materials, all these helped in the return of business confidence and the revival of business activity. Industrial relations improved, food situation in the country was much better than before, and industrial production went up. Apart from these favourable circumstances, certain special factors pushed up the prices of particular commodities. Thus anticipations of a short fall in the production of jute in Pakistan and India raised the price of raw jute and jute manufactures, while decontrol of tea in the United Kingdom and the restriction of exports of Ceylon tea caused tea prices in India to go up. Since August 1953, the effect of the end of war in Korea on general price level is seen in the decline of the general index number of prices from 410.4 in August to 403.8 in September and 389.4 in December. The return of peace did not, however, result in any serious recession because of the fact that peace negotiations were very prolonged so that

business had sufficient time to adjust itself to prospective changes in demand. In fact, in the first quarter of 1954, prices recovered and the general index stood at 402.6 in April.

### *Planned Development and Price Fluctuations*

It is advantageous to examine the price trends in India since 1953 as a distinct phase of the inflationary process that commenced more than a decade earlier. By the end of 1953 and the beginning of 1954 prices had recovered from the recession to the level which may be considered as relatively "normal". The period of planned development of the economy had started and with that in the subsequent years there has been on the whole a steady uptrend in prices. One distinct aspect of this period of rise is that price rise has been brought about mostly by an internal factor, namely, the incurring of large development expenditure by the government and the marked increase in the tempo of activity in the private sector. To focus attention on this aspect of the problem and to help comparison of price changes in the course of the years of planning with the position in the years immediately after the recession the government of India adopted a new series of index numbers of wholesale prices with 1952-53 as the base year.

TABLE 14  
MOVEMENT OF GENERAL PRICE LEVEL SINCE 1952-53  
(Base: 1952-53 = 100)

| Year    | All<br>commo-<br>dities | Food<br>Articles | Liquor<br>and<br>tobacco | Fuel<br>power<br>light<br>and<br>lubri-<br>cants | Indus-<br>trial<br>raw<br>mate-<br>rials | Total | Manufactures                  |                      |
|---------|-------------------------|------------------|--------------------------|--|--|-------|-------------------------------|----------------------|
|         |                         |                  |                          |  |  |       | Inter-<br>mediate<br>products | Finished<br>products |
| 1953-54 | 101.2                   | 100.1            | 95.6                     | 98.0   | 107.4                                    | 100.4 | 98.6                          | 100.7                |
| 1954-55 | 89.6                    | 82.1             | 85.0                     | 95.6   | 94.6                                     | 99.7  | 97.0                          | 100.1                |
| 1955-56 | 99.2                    | 94.6             | 78.4                     | 97.1   | 110.6                                    | 102.9 | 110.8                         | 101.6                |
| 1956-57 | 105.1                   | 101.7            | 87.8                     | 106.5  | 116.8                                    | 105.8 | 108.7                         | 105.4                |
| 1957-58 | 106.1                   | 103.4            | 94.4                     | 114.4  | 112.9                                    | 107.3 | 107.1                         | 107.4                |
| 1958-59 | 112.1                   | 112.7            | 98.9                     | 115.9  | 115.9                                    | 109.5 | 109.0                         | 109.5                |
| 1959-60 | 118.6                   | 116.5            | 97.1                     | 117.3  | 132.0                                    | 116.7 | 121.3                         | 116.0                |

(Source: *Reports on Currency and Finance*.)

Since 1952-53 prices have risen by about 20 per cent (Chart III). From the level reached in this year, there was a rather sharp decline in the next two years, food articles reaching the low of 81 in April 1955 (1952-53 = 100). Thus about the middle of 1955, the general level of prices in India was actually about 35 points lower than it was in March 1952. This sharp decline was due mostly to improved supply conditions, particularly of food articles, the prices of which declined to a much greater extent than that of the other groups. The wholesale price index of food articles came down from 117 in August 1953, to 81 in April 1955, a decline of 30 per cent, while the general index fell in the same period by 20 per cent. But from the middle of 1955, the last year of the First Plan period, prices again started moving up and have maintained a steady uptrend till now with a slight drop in 1957-58. From 88 in April 1955, the general index moved up more or less steadily to 117 in August 1957. To some extent this turn in the price level was something in the nature of a correction of the sharp downtrend in the previous one year or so. The set back in 1957-58 reflects the recessionary conditions obtaining in the U.S.A. and some European countries. But the undercurrent of an inflationary uptrend in prices which is noticeable throughout this period was due basically to the forces of demand and supply at home. While supply became scarce, due to lower output of cereals during 1954-55 and the rising exports of some industrial raw materials during 1955-56, consumption should have risen substantially consequent on rising money incomes following higher levels of investment expenditure. The sudden gush of development expenditure towards the close of the First Five Year Plan period, deficit financing on a substantial scale towards the close of the First Plan and the increasing reliance on this method of financing in the Second Plan period have resulted in an expansion of money supply and purchasing power with the public and a revival of inflationary conditions in the country.

A review of the price trends in India since the close of the war brings into prominent relief some salient features. In the first place, it may be stated broadly that price fluctuations up to 1952 were due mostly to external factors, while the instability in the later years has to be attributed largely to internal factors. The relative stability in the price structure, since the middle of 1948, following reimposition of controls, was rudely disturbed by the Korean boom and depression in 1951-52. Subsequent to 1952,

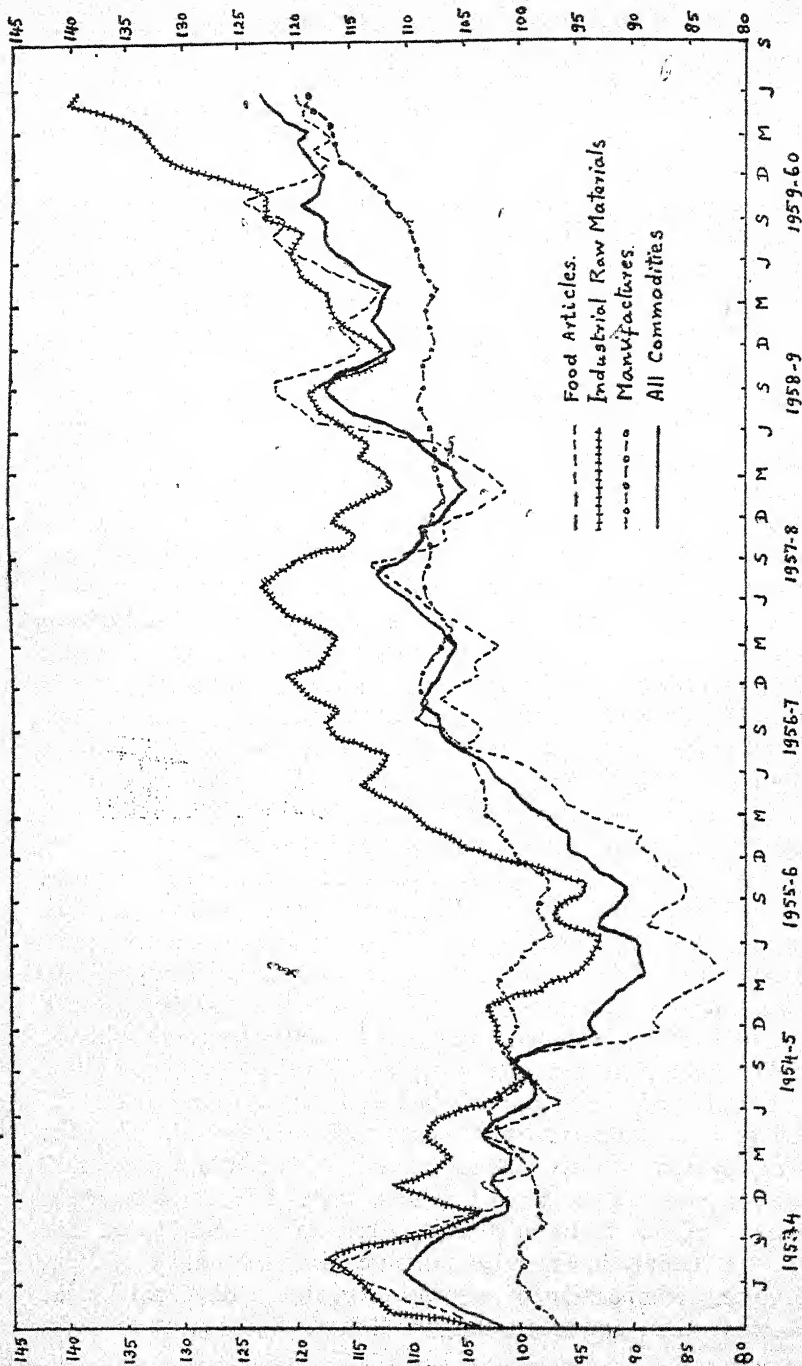


Chart III: Index Numbers of Wholesale Prices, 1953-60 (Base: 1952-53=100).



large outlays on development schemes, government's fiscal and monetary policy and varying domestic supply conditions account for price instability. Secondly, the indices of the manufactures group were consistently above the general index during the war and on the whole below the general index after the war with an exception during 1955. In the uptrend during the war, the lead was taken by manufactured goods, while in the post-war period it was the turn of industrial raw materials and the miscellaneous group. In a period of about one and a half years, from September 1949 when the rupee was devalued to April 1951 when the post-Korean peak was attained, industrial raw materials advanced by 49 per cent, while semi-manufactured and manufactured goods followed far behind, recording a rise of only 17 per cent and 18 per cent respectively. In the recession that followed the Korean boom, the prices of industrial raw materials came down by as much as 45 per cent, but that of semi-manufactured articles declined by 13 per cent and manufactured goods by 9 per cent. Since then industrial raw materials and semi-manufactured goods recovered, the former much more rapidly than the latter, while manufactured goods declined. It may be presumed that the wide bulge between the curves showing the movement of prices of industrial raw materials on the one hand and manufactures and general indices on the other (See Charts II and III) reflects partly the influence of international factors on the price structure in India and to a much greater extent, especially since 1955-56, the mounting demand at home resulting from rapid industrial progress. However, the decline in the general price level in 1954-55 was due mostly to the depression in food prices.

A comparison of the price indices in India during the war and in the subsequent years with that of other countries shows a disparity in the pattern of price movements. If the period of rapid rise in prices immediately following the outbreak of war up to the last quarter of 1942 is left out of account, it will be seen that the prices in foreign countries such as the U.S.A., the United Kingdom, Canada and Switzerland, unlike that in India, remained remarkably stable up to the middle of 1946. In those countries the greater portion of the price rise took place since the end of the war. In the United Kingdom the general index ranged between 106 and 171 during the war period, but after the close of the war, it went up from 171 in August 1945 to 335 in January 1952. In



the U.S.A. prices rose 34 per cent between September 1939 and August 1945; but in the post-war period between September 1945 and April 1951 increased by 75 per cent. On the other hand, in India the increase in the general level of prices subsequent to 1945 was only a continuation of the tendency which started when the war broke out. The general index recorded a rise of 144 per cent during the war period and 90 per cent between September 1945 and April 1951. Apart from this, price movements in India both in the war and in the post-war period were subject to much more violent fluctuations than in most other countries.

## CHAPTER IV

### VARIATIONS IN MONEY SUPPLY

THE modern view about prices is that a rise in their general level is brought about more as a result of increased spending activity than as a result of an expansion in the volume of money. The validity of this assumption is, however, questioned. It is true that prices at any particular period are pushed up by increased spending activity which normally draws out additional purchasing power from the source of money supply in the country. The direct antecedent of such augmented purchasing power may be a fall in the rate of interest, but this does not justify the ignoring of the part played by money in the sequence. For, as Robertson has pointed out, the order of events is first a change in the quantity of money which causes a change in the rate of interest.<sup>1</sup> It cannot also be disputed that monetary expansion is one of the principal ways in which purchasing power is expanded.<sup>2</sup> It is a truism that the money value of the national output during any period (which is the same as the spendings for output) is equal to the supply of money multiplied by its velocity so that increased spendings can be made possible either by increased volume of money, by increased velocity of circulation of money or by both. However, income velocity of money does not fluctuate widely except in very abnormal times. Hence if there is a persistent tendency for monetary incomes to increase over a period of years, the explanation should necessarily be found in the increase in money supply.<sup>3</sup> In general, an increase in the money balances with individuals as well as corporations leads to an increase in their spending on consumption or investment. Increased consumption expenditure has a direct impact on the prices of final goods which go up, while the extension of the operations of businesses which is implicit in larger outlay on investment pushes up the prices of raw materials and factors of production. In either case the effect is seen in the rise in prices.

Perhaps one explanation of the underestimation of money as

<sup>1</sup> *The Economic Journal*, September 1931, p. 405.

<sup>2</sup> Paul Einzig, *Inflation*, 1952, p. 63.

<sup>3</sup> Lauchlin Currie, *The Supply and Control of Money in the United States*, 1934, p. 6.

an active agent in this respect should be found in the fact that quite often at a period when money is cheap and credit is easily available the supply of money does not perceptibly affect price level or business activity. However, as Professor Max Millikan has pointed out, "monetary factors will be the yes or no factors in spending decisions of all kinds chiefly when money is scarce".<sup>1</sup> It is not necessary here to enter into the details of this controversial issue. But it is worth noting that the close relationship that exists between variations in money supply and the movement of prices is acknowledged by even those who dispute or deny the influence of money supply as a determinant of prices. It is the purpose of this chapter to review the changes in money supply in India since 1939 and to correlate these changes with price movements in the country in the same period.

### *The Constituents of Money Supply*

The total money supply of a country at any period of time is made up of all those media of exchange which can justifiably be termed as money. Thus the Federal Reserve System of the U.S.A. consider money supply as being constituted by those articles which perform the three functions of money, viz. means of payment, store of purchasing power and standard of value. On this basis of calculation, money supply is made up of circulating paper money, coins of all kinds and demand deposits held by banks.<sup>2</sup> That paper money and coins form two important items of money supply is too obvious to require any explanation. It should, however, be observed that of the total volume of coins and paper money available in a country at any particular point of time, only actual cash or currency in the hands of the public and of business firms should be included in the calculation of money supply. The bank's cash reserves are to be excluded, for otherwise there would be duplication in counting. This is because cash reserves are maintained by banks in order to meet the withdrawals of deposits. In the same way, unused note reserves of the central banks are also to be excluded because they become money only when they

<sup>1</sup> Max Millikan (ed.), *Income Stabilization for a Developing Democracy*, 1953, p. 162.

<sup>2</sup> *The Federal Reserve System—Purposes and Functions*, Third Edition, 1954, p. 5.

leave the vaults of the central banks and come into the hands of the money using public. The other important constituent of money supply is credit money. But of this only deposits subject to cheque, i.e., demand deposits or current deposits, are taken into account. Member bank deposits with the central bank are excluded for the same reason that cash held by banks is excluded. The justification for leaving out time deposits is that while they serve a store of value function, they are not themselves means of payment but only equivalent to means of payment. They are without doubt liquid assets, but they are not liquid enough to rank as money.<sup>1</sup>

The exclusion of time deposits and other instruments of credit should not, however, suggest that the line of distinction between articles which can be defined as money and which cannot is clear cut. In reality, the distinction between time deposits and demand deposits in respect of their quality as money is very much blurred. On the one hand, there are imperfections in the moneyiness of demand deposits. While demand deposits which have a quick turnover are very near allied to active currency, those demand deposits which remain idle for a substantial period have obviously doubtful significance as a constituent of money supply. Moreover, cheques drawn on demand deposits are not as easily acceptable as paper notes or coins and for that reason do not pass as currency in the same way and to the same extent as currency notes and metallic money do. On the other hand, there are some economists who argue that to the extent that time deposits serve as a store of value and are at times even used for making payments they should be treated as money. They would point out that at any rate there is no distinction from the economic point of view between hoarded money which remains idle in the hands of the public and unused overdraft facilities and time deposits. The latter two are as much cash as the first. There is some point in this argument. It may, however, be clearly seen that the standpoint of these writers is based on a much wider interpretation of the term "money" than would be justified for purposes of analysis. The difficulty of making an exclusive definition of money has been brought out clearly by Professor J. W. Angell.<sup>2</sup> He has attempted

<sup>1</sup> Edward S. Shaw, *Money, Income and Monetary Policy*, 1950, p. 37.

<sup>2</sup> Thus he says: "Between currency in active circulation at one extreme and savings deposits at the other, there is (hence) no sharp distinction that is unmistakably manifest in the available statistics or in those operations that involve



to find a way out of this difficulty by making use of three definitions of money based on three categories of money. Thus according to him, "total money" would include time deposits; circulating money excludes time and savings deposits and active money is circulating money minus money that is hoarded. Of these three categories of money the one that is of use for analytical requirements is the second, i.e. circulating money.<sup>1</sup> At any rate, if the concept of money supply is to be of any practical significance the line of distinction between money and not money should be drawn somewhere. Most of the modern economists exclude from the category of money time deposits and other instruments of credit, such as bills of exchange, banker's acceptances, treasury bills, etc. If time deposits were to be included among the constituents of money supply, then there would be no proper justification for the exclusion of the other kinds of interest-bearing securities. Hence the boundary line is usually drawn between time deposits and demand deposits. Thus money supply would consist of the following items:

- (a) Currency or circulating coins and paper currency, i.e. total volume of coins and currency notes minus cash held by banks.
- (b) Credit, i.e. current account balances or demand deposits minus inter-bank demand deposits and deposits of banks with the central bank.

The relative size of the different constituents of money supply in a country indicates the conditions under which variations in the volume of money can normally occur and also the means which can be adopted for effecting such variations. In a country which has adopted an inconvertible paper currency and in which credit money is fairly well developed, changes in money supply can be caused by the following means: (1) The supply of paper currency can be increased by the central bank or other currency authority up to the maximum limit allowed by law. (2) Credit expansion by the banking system increases the volume of money.

money; rather, there is a series of blurred gradations which are much less clear in the empirical material than they are in *a priori* logic". *The Behaviour of Money*, 1936, p. 8.

<sup>1</sup> W. R. Lane and G. Price, "Money Supply in Australia", *The Economic Record*, November 1952, p. 274.



By lowering the reserve requirements which the commercial banks have to maintain with the central bank the limit to which credit can be expanded by the former is raised. Besides, the central bank can by using its power to create credit for the government or for the commercial banks increase the money supply. (3) Variations in the community's choice between demand deposits and cash to some extent determine the quantity of money, especially in a country where credit money forms the predominant item of money supply. This follows from the simple fact that when more money is held in the form of deposits with the banks, the bank reserves for credit expansion are increased and on the basis of such augmented reserves the banks can increase the volume of credit money. (4) Similarly, the shift in the community's preference for time or savings deposits on the one hand and demand deposits on the other has a direct effect on money supply. In so far as demand deposits constitute money while time deposits do not, conversion of the latter into the former increases the volume of money. As against this, if at any time the community's preference for time or savings deposits increases, to that extent there is a restriction in money supply. (5) Large surpluses in the balance of payments have an expansive effect on the volume of money. A favourable balance of payments causes an increase in foreign assets or in the currency holdings or bank deposits of private export interests. In either case, the result is the possibility of monetary expansion. (6) Lastly, government's budget surpluses have a dampening effect on money supply while a running down of the government's balances in the treasury or on deposit with banks has the opposite effect. Quite frequently these factors may be operating in opposite directions. It is likely that the forces tending towards an increase of money supply may be just offset by opposite forces, producing as a consequence a neutral effect on the quantity of money. Hence, at any period of time, the extent to which money supply expands or contracts depends on the predominance or otherwise of the positive factors.

In India the chief source of money supply is the central bank of the country, the Reserve Bank of India. It is true that the credit supplied by the unorganized sector performs in a large measure some of the important functions of money. Such facilities provided by the unorganized sector for financing small scale agricultural operations and small business units are sometimes more important

than that supplied by the organized sector. Nevertheless, in the absence of precise information, these have to be left out in the analysis of money supply in the country. As a source of money supply, the Reserve Bank occupies a much more important position than commercial banks because by far the most important constituent of money supply in India is currency, that is paper money and metallic money. Thus at the end of March 1960, notes and rupee coins in circulation in India were of the value of Rs. 1932 crores while the demand liabilities, excluding inter-bank deposits of the scheduled, non-scheduled and co-operative banks amounted to Rs. 819 crores. This would mean that demand deposits formed only 30 per cent of the total money supply.<sup>1</sup> On the other hand, in an economically advanced country like the U.S.A., demand deposits constitute about 75 per cent of the total volume of money.

On the basis of the principle indicated earlier, the total money supply in India (meaning, all forms of exchange media held by the community) would be the sum of the following two items:

- (1) Notes and coins in circulation minus balances of Central and State Governments held in Treasuries minus cash on hand of scheduled, non-scheduled and co-operative banks.
- (2) Net demand liabilities<sup>2</sup> of scheduled, non-scheduled and co-operative banks plus deposits with the Reserve Bank excluding those of Central Government and banks.

### *Seasonal Variations in Money Supply*

The volume of money in circulation in a country is subject to two kinds of variation—the one seasonal and the other a relatively long period type. Seasonal fluctuation in the supply of money

<sup>1</sup> This is a characteristic feature of under-developed economies. The proportion of demand deposits to the total quantity of money is between 30 per cent and 40 per cent in India, Burma, Malaya and Pakistan. Among the Asiatic and Far East countries, Japan and Ceylon are exceptions in this respect, with demand deposits forming more than 60 per cent of their money supply. See, *Economic Survey of Asia and the Far East*, United Nations, 1950, p. 461.

<sup>2</sup> That is, demand liabilities excluding inter-bank demand deposits. Since figures relating to inter-bank demand deposits of scheduled banks are available only from July 1948, deduction on this account has been made only since 1949-50. Similar deductions in the case of non-scheduled banks have been made with effect from 1951-52.

is caused by the simple fact that the community's demand for money for transaction purposes increases in the busy season and contracts in the slack season. As a result there is greater absorption of money during certain months of the year and return of money in the other months. In India, since the larger part of money supply consists of notes and coins, seasonal variations in money supply relate mostly to changes in the volume of currency in circulation. In fact, as would be shown presently, seasonal absorption and return of deposit money move just opposite to the variations in currency supply. In most parts of the country the busiest part of the year is the last and the first quarter and the slack season is covered by the six months, from April to September. Usually the lowest level of the slack season is reached in August and September and the maximum height of the busy period is attained somewhere in the first or second month of the year. The seasonal variation in currency absorption in the years immediately preceding the outbreak of war conformed to this general pattern.

This fairly regular seasonality in the absorption and return of currency tended to be distorted after the outbreak of war. The ascending tempo of economic activity in the country and the sharp rise in the level of government expenditure caused an unprecedented, rapid and steady increase in the demand for currency which appreciably smoothened out the seasonal rise and fall of currency. Thus during the two "slack" seasons of 1940-41 and 1941-42 there was a net absorption of currency instead of the usual return. The demand for currency during the slack seasons of 1940-41, 1943-44 and 1945-46 exceeded the busy season absorption during these years. The considerable increase in the volume of currency was brought about by an increase in the rate of absorption during the busy seasons and also by an abnormal lengthening out of the period of absorption and the narrowing down of the periods of return. Thus the period of absorption that began in September 1939 did not stop as it should normally have stopped in the first quarter of 1940 but continued till the end of June 1940. Similarly, the next period of absorption extended over 9 months from October 1940 to June 1941. During the entire period from August 1941 to June 1944, a period during which war-time monetary expansion reached its peak, there was continuous absorption of currency. Between August 1944 and the end of 1945 there was return of currency only in one month, July 1945. However, although war-

time developments submerged for the time being the regular periodicity in the seasonal variations in currency supply, yet the outlines of the pattern survived and the seasonal force in the absorption and return of currency is indicated by the fact that even during the war period there was on the whole seasonal variation in the rate of absorption of currency, the rate reaching its lowest levels in the month of July.

While the ebb and flow of currency conformed in a normal period (as in the years immediately preceding the outbreak of war) to a general pattern determined by the degree of business activity, the movement in deposit money showed an opposite trend. Before the war, note circulation tended to rise and demand deposits to contract in the busy season, and *vice versa* in the slack season. During war years this difference in the seasonal movement of the two constituents of money supply nearly disappeared in consequence of the inflationary expansion of both currency and credit. Nevertheless, a difference in the rate of expansion of the two forms of money during this period is observable. During the busy seasons there was a relatively greater increase in note circulation than in demand deposits. The normal pattern in the movements of both currency and deposit money began to re-emerge after the close of the war. In the slack season of the first full post-war year, 1946-47, note circulation declined by 3 per cent while deposits rose by 7 per cent; in the same year during the busy season there was an expansion of 5 per cent in note circulation and a contraction of 9 per cent in demand deposits. This recovery received a setback in the next year when as a result of expansion of credit by banks and increased government disbursements deposit money went up by 7 per cent in the busy season. In 1948-49 the normal seasonal trends again manifested themselves and have continued in the case of currency, though not in the case of deposit money without much interruption since then. One significant change in the last few years may, however, be noted. The contraction in the slack period tends to become relatively less pronounced while the expansion during the busy season is growing. At the same time demand deposits show an increase both in the slack and busy seasons. This change indicates the natural consequence of a rapid growth in the secondary and tertiary sectors in relation to the primary sector and the higher tempo of economic development (See Table 15).



TABLE 15

## SEASONAL VARIATIONS IN MONEY SUPPLY

(In crores of rupees)

| <i>Months</i>   |   | <i>Currency with<br/>the Public*</i> | <i>Demand<br/>Liabilities†</i> |
|-----------------|---|--------------------------------------|--------------------------------|
| 1. Slack season |   |                                      |                                |
| 2. Busy season  |   |                                      |                                |
| 1943-44         | 1 | + 113                                | + 90                           |
|                 | 2 | + 118                                | + 64                           |
| 1944-45         | 1 | + 59                                 | + 64                           |
|                 | 2 | + 144                                | + 9                            |
| 1945-46         | 1 | + 57                                 | + 48                           |
|                 | 2 | + 77                                 | + 56                           |
| 1946-47         | 1 | — 31                                 | + 47                           |
|                 | 2 | + 34                                 | — 67                           |
| 1947-48         | 1 | — 68                                 | + 18                           |
|                 | 2 | + 130                                | + 50                           |
| 1948-49         | 1 | — 55                                 | + 19                           |
|                 | 2 | + 47                                 | — 57                           |
| 1949-50         | 1 | — 125                                | + 8                            |
|                 | 2 | + 122                                | — 15                           |
| 1950-51         | 1 | — 110                                | + 18                           |
|                 | 2 | + 220                                | — 1                            |
| 1951-52         | 1 | — 193                                | — 9                            |
|                 | 2 | + 53                                 | — 29                           |
| 1952-53         | 1 | — 91                                 | — 21                           |
|                 | 2 | + 88                                 | — 1                            |
| 1953-54         | 1 | — 100                                | — 10                           |
|                 | 2 | + 133                                | + 11                           |
| 1954-55         | 1 | — 67                                 | + 21                           |
|                 | 2 | + 157                                | + 35                           |
| 1955-56         | 1 | — 12                                 | + 22                           |
|                 | 2 | + 207                                | + 42                           |
| 1956-57         | 1 | — 96                                 | — 8                            |
|                 | 2 | + 144                                | + 94                           |
| 1957-58         | 1 | — 90                                 | + 5                            |
|                 | 2 | + 143                                | + 24                           |
| 1958-59         | 1 | — 87                                 | — 71                           |
|                 | 2 | + 219                                | + 68                           |
| 1959-60         | 1 | — 57                                 | — 53                           |
|                 | 2 | + 201                                | + 73                           |

\* Up to 1951-52 notes only; since 1952-53 includes rupee coins.

† Up to 1948-49 inclusive of inter-bank demand deposits; since 1949-50, net.  
(Source: *Reports on Currency and Finance*, Reserve Bank of India.)



*Long-Term Variations in Money Supply*

Seasonal variations in money supply indicate the extent to which changes in business activity occurring normally in annual cycles affect the community's demand for money. On the other hand, long term variations in money supply extending over periods of ten or fifteen years reflect the more fundamental changes in a country's economy caused by both internal and external factors. Expansion or contraction of money supply of this character is caused by the balance of payments position of the country as well as by the action of the government, the central bank, the commercial banks and the public in the monetary field. Thus, a favourable balance of payments, budgetary deficits, increase in the central bank's holdings of government securities issued in earlier years, rise in the advances of commercial banks or/and in the value of Bills discounted by them, and shift in the preference of the public from time and savings deposits to demand deposits, all these have an expansionary effect on money supply, while reverse tendencies have the opposite effect. All these factors have been operative in India during the last twenty years. At times their effects have been cumulative, with the result that the volume of money supply went up sharply in certain years, while at other times they have showed opposite trends, thereby neutralizing their respective influences and moderating considerably the fluctuations in money supply. The extent to which these various expansionary forces influenced money supply in the country since the outbreak of war may now be examined in some detail.

The total money supply (excluding small coins) in India (undivided) increased from Rs. 463 crores at the end of 1938-39 to Rs. 2,237 crores at the end of 1947-48. This was made up of an increase from Rs. 287 crores to Rs. 1,415 crores in currency and an increase from Rs. 176 crores to Rs. 822 crores in deposit money. Thus both currency and demand deposits increased during this nine-year period by about five times. Figures relating to the volume of money in circulation in the Indian Union in 1948-49 are not available. The trends in money supply since 1950-51 fall into two phases. In the two years 1951-53 money supply declined by Rs. 215 crores, the bulk of which occurred in 1951-52. Over the next six years money supply rose by Rs. 733 crores, the annual rate of increase going up from 1.7 per cent to 7 per cent. The net increase in money supply

TABLE 16  
MONEY SUPPLY(a) IN UNDIVIDED INDIA, 1938-39 TO 1947-48  
(In crores of rupees)

| Year    | Currency |                  |                          |                           |  | Deposit money                      |                              |   |   |                          |                |   |   |   |  |  |  |
|---------|----------|------------------|--------------------------|---------------------------|--|------------------------------------|------------------------------|---|---|--------------------------|----------------|---|---|---|--|--|--|
|         | Notes    | Rupree coins (e) | Balances with treasuries | Cash on hand of banks (b) | Total currency with the public (1+2-3-4) | Variations in currency with public | Demand deposits of banks (c) | Deposits of Central Govt. with the Reserve Bank | Deposits of banks with the Reserve Bank | Deposits of other govts. | Other deposits | Deposit money with the public (7+10+11) | Variations in deposit money with the public | Total money supply with the public (5+12) | Variations in money supply with the public |  |  |
|         | 1        | 2                | 3                        | 4                         | 5  | 6                                  | 7                            | 8   | 9                                       | 10                       | 11             | 12                                      | 13  | 14  | 15   |  |  |
| 1938-39 | 178      | 120              | 2                        | 9                         | 287                                      | —                                  | 168                          | 9   | 11                                      | 7                        | 1              | 176                                     | —   | 463                                       | —  |  |  |
| 1939-40 | 225      | 120              | 2                        | 10                        | 333                                      | + 46                               | 187                          | 8   | 18                                      | 11                       | 1              | 199                                     | + 23  | 532                                       | + 69                                       |  |  |
| 1940-41 | 241      | 120              | 2                        | 13                        | 346                                      | + 13                               | 215                          | 5   | 35                                      | 12                       | 6              | 233                                     | + 34  | 579                                       | + 47                                       |  |  |
| 1941-42 | 382      | 122              | 2                        | 16                        | 486                                      | + 140                              | 276                          | 7   | 42                                      | 12                       | 2              | 290                                     | + 57  | 776                                       | + 197                                      |  |  |
| 1942-43 | 644      | 124              | 1                        | 25                        | 742                                      | + 256                              | 435                          | 19  | 47                                      | 16                       | 5              | 456                                     | + 166                                       | 1198                                      | + 422                                      |  |  |
| 1943-44 | 882      | 137              | 2                        | 34                        | 983                                      | + 241                              | 596                          | 76  | 50                                      | 25                       | 15             | 636                                     | + 180                                       | 1619                                      | + 421                                      |  |  |
| 1944-45 | 1085     | 147              | 3                        | 41                        | 1188                                     | + 205                              | 682                          | 254   | 85                                      | 29                       | 23             | 734                                     | + 98  | 1922                                      | + 303                                      |  |  |
| 1945-46 | 1219     | 166              | 7                        | 44                        | 1334                                     | + 146                              | 742                          | 521   | 71                                      | 36                       | 9              | 787                                     | + 53  | 2121                                      | + 199                                      |  |  |
| 1946-47 | 1242     | 168              | 2                        | 45                        | 1363                                     | + 29                               | 719                          | 432   | 71                                      | 30                       | 16             | 765                                     | + 22  | 2128                                      | + 7  |  |  |
| 1947-48 | 1304     | 155              | 1(d)                     | 44                        | 1415                                     | + 52                               | 777                          | 320   | 79                                      | 24                       | 21             | 822                                     | + 57  | 2337                                      | + 109                                      |  |  |

(a) Excludes small coins; year-end figures.

(b) Scheduled, non-scheduled and co-operative banks.

(c) Inclusive of inter-bank demand deposits of scheduled banks.

(d) Relates to Indian Union only.

(e) Estimated figures up to 1940-41.

(Source: Reports on Currency and Finance, Reserve Bank of India.)

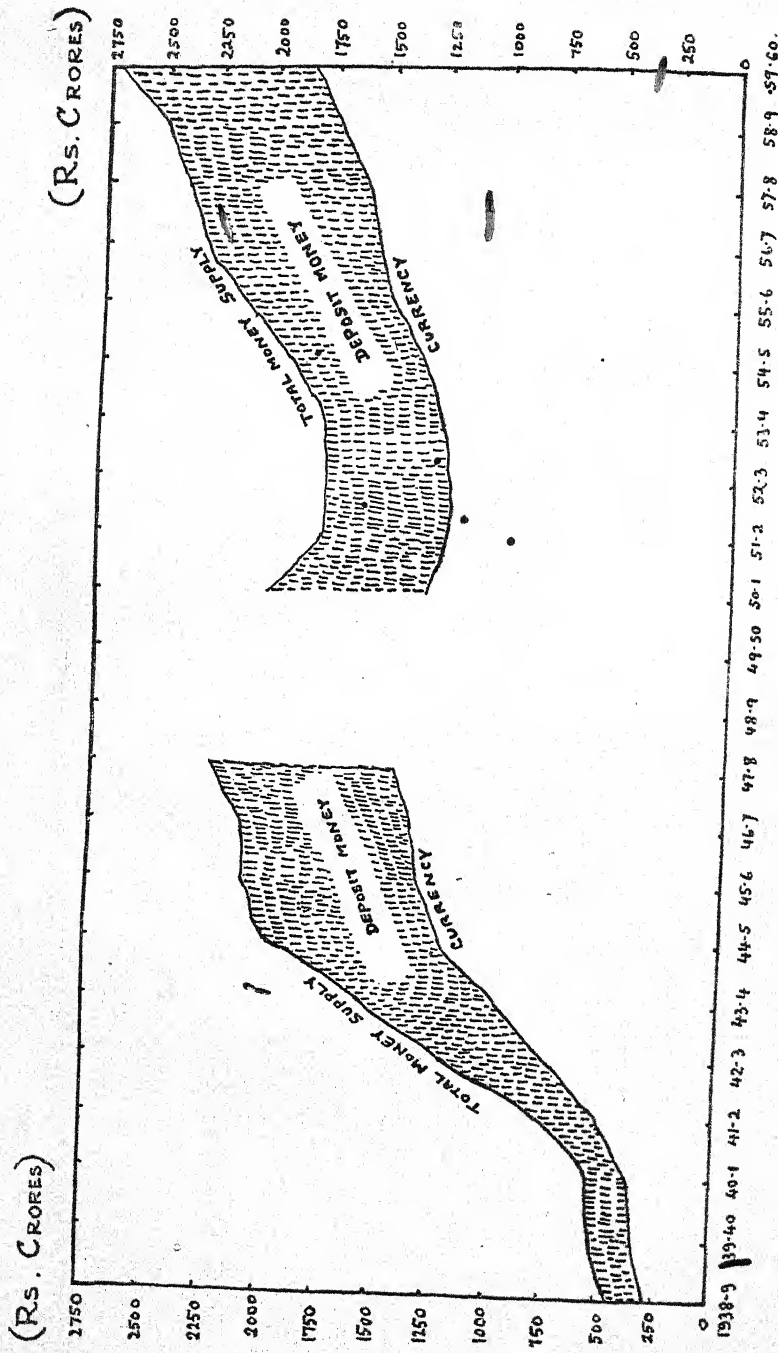


Chart IV: Movements in Money Supply, 1938-39 to 1959-60.

as a result of increased demand for finance from the commodity markets, the stock exchange and the silver market, the deposits of the commercial banks showed a substantial rise. The total liabilities of the scheduled banks increased from Rs. 238 crores in March 1939 to Rs. 259 crores in March 1940; advances showed a corresponding rise. This sign of increased business activity was, however, short lived. On the whole, in the second year of the war money remained easy, there being no great increase in demand even in the busy season. The call money rate in both Bombay and Calcutta receded sharply, while the Imperial Bank's hundi rate declined from  $3\frac{1}{2}$  per cent to 3 per cent. Nevertheless, the expansion in the volume of notes and rupee coins in circulation continued. The tendency of rupee coins to return which continued since 1920-21 was reversed on the outbreak of war and a steady outflow of rupees ensued. The holding of rupee coins in the Issue Department of the Reserve Bank which had stood at more than Rs. 75 crores on 1st September 1939 came down below the statutory limit by Rs. 50 crores to Rs. 35 crores by the middle of 1940. The fact that absorption of rupee coins increased to an unprecedented extent indicates that increase in the supply of currency was due to increased hoarding activity rather than to genuine business activity. This trend, however, was arrested with the promulgation by the Government of India of a rule under the Defence of India Act making it an offence for any person to acquire coin in excess of his personal or business requirements. The issuing and putting into circulation of one rupee notes and the withdrawal of Victoria rupee coins very much helped in easing the situation. Thus the absorption of rupee coins in 1941-42 amounted to only Rs. 7 crores against Rs. 33 crores in the previous year and Rs. 10 crores in 1939-40. This, however, does not indicate that the hoarding activity which started in the wake of the war had abated. In actual fact, while in consequence of the Ordinances referred to above, hoarding of rupee coins was considerably restricted, the same tendency now came to manifest itself in the case of small coins. Since September 1939 till March 1942 there was no net return of small coins in any month and their total absorption during this period was approximately Rs. 12 crores which was very much in excess of the absorption during the entire period of the First World War. The conclusion therefore emerges that while the outbreak of war led to some initial spurt in business activity, it

had very soon cooled down and the phenomenal increase in the absorption of currency is not a measure of the monetary requirements of the community for business purposes.

Between 1941 and 1945 there was an enormous increase in the volume of money in circulation. Of the total increase of Rs. 1,774 crores between 1939 and 1948, the four years, 1941-45, accounted for Rs. 1,343 crores or more than 70 per cent. During the war, notes in circulation increased by about  $5\frac{1}{2}$  times, while demand deposits rose by over 4 times. Expansion in note circulation reached its highest rate in the busy season of 1941-42 and that of demand deposits in the slack season of 1942-43. Details of war-time absorption of currency are given in Table 18.

TABLE 18  
WAR-TIME ABSORPTION OF CURRENCY  
(In lakhs of rupees)

| <i>Period</i>           | <i>Notes*</i> | <i>Rupee Coin*</i> | <i>Small Coin†</i> | <i>Total</i> |
|-------------------------|---------------|--------------------|--------------------|--------------|
| Sept. 1939 to Aug. 1940 | 5260          | 5282               | 450                | 10992        |
| Sept. 1940 to Aug. 1941 | 4510          | — 384              | 396                | 4522         |
| Sept. 1941 to Aug. 1942 | 22600         | 1174               | 712                | 24486        |
| Sept. 1942 to Aug. 1943 | 28038         | 5495               | 1458               | 34991        |
| Sept. 1943 to Aug. 1944 | 17237         | 1643               | 2081               | 20961        |
| Sept. 1944 to Aug. 1945 | 21244         | 1006               | 1662               | 23912        |
| TOTAL                   | 98889         | 14216              | 6759               | 119864       |

\* Excluding Burma since April 1942.

† Excluding Burma since February 1942.

(Source: *Report on Currency and Finance, 1945-46*, Reserve Bank of India.)

How was this phenomenal increase in money supply during the war made possible? The substantial increase in the demand liabilities of scheduled banks from Rs. 140 crores in 1939-40 to more than Rs. 650 crores in 1945-46, which was proportionately much higher than the increase in time liabilities<sup>1</sup> and the rise in the value

<sup>1</sup> In the same period time liabilities increased from Rs. 106 crores to Rs. 260 crores.



of advances and bills discounted may suggest that this part of monetary expansion represented expansion of a secondary type. This, however, is not quite true. In actual fact, secondary expansion in money supply was rather small. The relative insignificance of secondary expansion is borne out by the fact that although during the war period there was an absolute rise in the value of advances and bills discounted, yet in the same period the proportion of this value to total demand and time liabilities declined from 53 per cent to as low as 24 per cent in 1942-43 and recovered only to 30 per cent at the end of the war. In reality, in consideration of the fact that expansion of private economic activity was regulated during war period and that the available resources of the banking system were geared to the supply of funds to government through investment in government securities, credit expansion of any notable magnitude cannot be looked for.<sup>1</sup> On the other hand, expansion in currency supply was quite phenomenal. This was the net result of two expansionary forces, rise in sterling balances and increase in budgetary deficits offset to some extent by rise in government's cash balances and the increase in government's rupee debt. Table 19 furnishes details of this development.

The close connection between the accrual of sterling and the expansion in the volume of money is obvious. Under the provisions of the Reserve Bank of India Act, the bank has to maintain in its Issue Department gold coins and bullion of the value of Rs. 40 crores; there is no restriction in respect of the sterling securities which the Issue Department can hold. Under agreements with the British Government, the Government of India was to provide the rupee finance needed by the former in India against payments in sterling. By transferring the sterling balances thus acquired from the Banking Department to the Issue Department the Reserve Bank of India provided the necessary rupee finance. Thus the supply of rupee notes in India came to increase in correspondence with the accumulation of sterling balances which increased rapidly with the outbreak of war as a result of the disbursement of funds on account of the Government of U.K., by a favourable balance of trade, by the export and sale of precious metals and also by the payments made for some time in sterling by the Government of U.S.A. for the upkeep of American troops in India. This explains the enormous increase in the net accrual of sterling. The rate of

<sup>1</sup> *Reserve Bank of India Monthly Bulletin*, September 1950, p. 609.

TABLE 19

## THE SOURCES OF MONEY SUPPLY

(In crores of rupees)

|  | 1939-<br>40 | 1940-<br>41 | 1941-<br>42 | 1942-<br>43 | 1943-<br>44 | 1944-<br>45 | 1945-<br>46 |
|--|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| 1. Total net accrual of sterling to end of each year (April-March)   | 100         | 191         | 441         | 828         | 1278        | 1710        | 2071        |
| 2. Budget deficit including defence capital expenditure—progressive  | —           | 7           | 19          | 184         | 411         | 626         | 835         |
| 3. Totals of 1 and 2   | 100         | 198         | 460         | 1012        | 1689        | 2336        | 2906        |
| 4. Increase in note circulation, rupee coin and small coin circulation, and in total deposits of banks         | 83          | 167         | 373         | 868         | 1358        | 1733        | 2073        |
| 5. Increase in deposits with the Reserve Bank (of which addition to Central Government's balances—progressive) | 9           | 46          | 34          | 58          | 112         | 346         | 599         |
|  | (4)         | (11)        | (19)        | (13)        | (50)        | (255)       | (538)       |
| 6. Totals of 4 and 5   | 92          | 213         | 407         | 926         | 1470        | 2079        | 2672        |
| 7. Increase in the rupee debt of the Central Government since 31st March 1939—progressive                      | 18          | 152         | 231         | 497         | 623         | 851         | 1217        |

(Source: *Reserve Bank of India Monthly Bulletin*, September 1950.)

acquisition of sterling securities slackened to some extent towards the close of the war, but from the point of view of its being a source of monetary expansion in India this was offset by the rapid increase in budgetary deficits since 1942-43. At the same time, increase in the cash balances of the government and in the rupee debt should have exerted a deflationary effect and thereby should have modified to some extent the expansionary force of sterling securities and budget deficits.

With the termination of the war, the rate of expansion in money supply showed a tendency to decline markedly which continued with some minor aberrations till 1950. The annual rate of expansion in currency came down to 2 per cent in 1946-47 from 12 per cent in 1945-46, 23 per cent in 1944-45, 37 per cent in 1943-44 and 69 per cent in 1942-43. This was the result of a combination of factors, such as a considerable fall in defence expenditure, continued adverse balance of payments caused by larger merchandize imports, and the anti-inflationary policy of the government, consisting of vigorous loan and taxation programmes and official sales of bullion. In 1947-48, however, due partly to heavy governmental outlays on refugee relief, defence and food subsidies as well as on capital account, the declining tendency in currency absorption was arrested. The total currency absorption in that year was higher at Rs. 53.97 crores against Rs. 31.11 crores in the previous year. As a result of the gradual widening of the free sector of internal trade following decontrol, the annual net increase in the cash balances with the public which came down from Rs. 470 crores in 1942-43 to Rs. 251 crores in 1945-46 and to Rs. 26 crores in 1946-47 went up again to Rs. 108 crores in 1947-48. But the downtrend in the rate of absorption of currency was resumed in the next year. Although figures relating to the year 1948-49 for the Indian Union are not available, the indications are that deflationary forces were active during these years resulting in a shrinkage in the volume of money supply. Demand deposits in the Indian Union and Pakistan together declined from Rs. 749 crores in the second half of 1947-48 to Rs. 688 crores in the first half and to Rs. 631 crores in the second half of 1948-49. In fact, while the rate of absorption of currency considerably slackened after the end of the war, 1948-49 was the first year when there was a net contraction of currency since 1938-39.<sup>1</sup> The net decrease in money supply for the Indian Union alone in 1948-49 has been calculated at Rs. 43.26 crores.<sup>2</sup> The downtrend continued in the next year when money supply came down to Rs. 1865.3 crores representing a decline of Rs. 18.67 crores from the previous year. The return of currency in the slack season of 1949-50 was the largest seasonal contraction on record—Rs. 113.30 crores. This was due partly to the liberalization of import controls in July 1948 which caused a deficit in the balance of payments and

<sup>1</sup> *Report on Currency and Finance, 1949-50*, p. 128.

<sup>2</sup> *Report on Currency and Finance, 1953-54*, p. 115.

substantial net sales of sterling by the Reserve Bank of India. Although in the busy season of 1949-50 there was a substantial absorption of currency—the effect of an export surplus and purchase of sterling following devaluation—this was less than the return in the preceding slack season, so that in the year as a whole there was net decrease in the volume of money with the public.

### *Money Supply since 1950-51*

Fluctuations in money supply since 1950-51 are the result of an external factor, the war in Korea, and internal factors, such as government's monetary policy and increasing developmental expenditure with the inauguration of the Five Year Plan. The outbreak of the war in Korea in the middle of 1950 gave a stimulus to business activity and to exports resulting in surpluses in the balance of payments. This is reflected in the increase in the foreign assets of the Reserve Bank of India and also in the volume of credit created by scheduled banks in the form of advances and bills discounted. In order to prevent credit and monetary conditions getting out of control the Reserve Bank brought into use some of its control weapons. The raising of the bank rate from 3 to  $3\frac{1}{2}$  per cent in November 1951 resulted in the raising of the lending rates of commercial banks also by an equivalent of  $\frac{1}{2}$  per cent. Simultaneously, by withdrawing its support from government securities, bond yields were raised, which created stringency conditions in the money market. This step which represented a significant departure from the earlier policy of guaranteeing the market price of government securities, had the effect of arresting the process of disinvestment in these securities by the commercial banks since 1949. Although this policy was reversed subsequently, it stopped for the time being the "monetizing" of government securities through loan expansion by commercial banks. The Reserve Bank tried also the technique of selective credit control and moral suasion. Immediately after the devaluation of the rupee in September 1949, the Reserve Bank required banks to submit daily returns of new loans sanctioned amounting to Rs. 100,000 and above. Besides, other directives were given to commercial banks against the granting of speculative loans, as for example, the advice to "go slow" in respect of advances against bullion (May 1951). This timely action had its effect. And although the marked downtrend in money supply and prices in



1952 cannot entirely be attributed to monetary policy, yet the fact that the strict monetary measures adopted by the central bank created tight conditions in the money market and curbed a speculative up-thrust in prices cannot be denied. However, economic forces operating inside the country reasserted themselves as a major determinant in the matter of money supply. Increasing developmental expenditure under the Five Year Plan, deficit budgets and decreasing cash balances of the government account mostly for the larger absorption of money since 1953-54. The relative significance of these expansionary and contractionary factors operating in the years 1949-50 to 1959-60 is brought out in Table 20.

It may be easily seen from the figures in this table that the increase in the money supply of nearly Rs. 120 crores in 1950-51 was to a large extent due to the unusual increase in the expansion of bank credit. Scheduled bank credit shows an advance of Rs. 85 crores against a decline of Rs. 34 crores in the previous year. Surplus balance of payments, as indicated by the increase in the Reserve Bank's holding of foreign assets, and additions to rupee securities also contributed to increase in money supply, moderated however to some extent by a rise in government balances with the bank. The considerable fall in money supply in 1951-52 of about 175 crores of rupees is accounted for to a large extent by the sharp decline in foreign assets. The import of foodgrains under the U.S. Wheat Loan, licensing of substantial imports of raw cotton from the U.S.A. and the fall in external demand for stockpiling and rearmament purposes were largely responsible for the adverse turn in the balance of payments in that year. Increase in government balances and fall in the Reserve Bank's holdings of rupee securities also had a negative influence on money supply. The Reserve Bank's open market purchases were limited in amount and scope in 1951-52 as compared to the previous year. Similarly, although there was expansion of credit by scheduled banks, the increase was only half of that of 1950-51. On the whole, the scheduled banks adopted a cautious policy in conformity with the new monetary policy of the central bank. Decline in money supply, which began in 1951-52, continued in the next year, but in 1953-54 there was once again an expansion in money supply of the order of Rs. 29 crores. Among the factors which account for expansion, scheduled bank credit was largely neutral in its effect, while payment surplus and budgetary deficit of the Union Government



TABLE 20

## VARIATIONS IN MONEY SUPPLY

(In crores of rupees)

|  | 1949-50 | 1950-51 | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | 1951-56<br>(Total) | 1956-57  | 1957-58  | 1958-59 | 1959-60 | 1956-60<br>(Total) |
|--|---------|---------|---------|---------|---------|---------|---------|--------------------|----------|----------|---------|---------|--------------------|
| 1. Total money supply with the public            | -18.7   | +118.84 | -174.92 | -39.08  | +29.26  | +126.65 | +263.68 | 205.6              | +128.6   | +75.9    | +109.0  | +202.3  | +515.8             |
| 2. Central Government deposits with Reserve Bank | -54.7   | +32.8   | +18.1   | -44.4   | -70.0   | -6.3    | +7.9    | -94.7              | -2.8     | -16.2    | +5.5    | +9.3    | -4.2               |
| 3. Foreign assets held by the Reserve Bank*      | -85.4   | +25.4   | -161.1  | +0.6    | +29.3   | -23.0   | +16.1   | -138.1             | -219.3   | -259.8   | -53.9   | -15.9   | -548.9             |
|  |         |         |         |         |         |         |         |                    | (-274.1) | (-294.3) | (-53.9) | (-5.2)  |                    |
| 4. Rupee securities held by the Reserve Bank     | +22.5   | +69.9   | -19.1   | -20.8   | -58.5   | +65.8   | +172.7  | +140.2             | +280.2   | +403.4   | +133.4  | +151.6  | +968.6             |
| 5. Scheduled bank credit                         | -34.1   | +84.6   | +45.7   | -51.4   | +6.4    | +65.7   | +148    | +214.2             | +152.0   | +66.3    | +64.3   | +146.2  | +428.8             |

\* Figures in brackets are net of borrowings from and repayments to the I.M.F.  
(Source: *Reports on currency and Finance*, Reserve Bank of India.)

exerted an expansionary force. The decline in the Reserve Bank's holdings of rupee securities by Rs. 58 crores should have operated in favour of a decline in money supply but the contractionist effect of this decline was mitigated to some extent by the fact that only part of this fall in the Reserve Bank's rupee securities represented sale to the non-banking sector.<sup>1</sup> The expansion in money supply to the extent of Rs. 390 crores in the last two years of the First Plan period was due largely to the considerable increase in the Reserve Bank's holding of rupee securities and scheduled bank credit. The effect of a small decline in government balances with the bank and the fall in the foreign assets held by the Reserve Bank in 1954-55 was offset by a reverse trend in the next year. In the first four years of the Second Plan period money supply with the public increased by Rs. 129 crores, Rs. 76 crores, Rs. 110 crores and Rs. 202 crores respectively. This comparatively moderate rise in spite of large budgetary deficits in the public sector was due largely to continued balance of payments deficits and a substantial rise in time deposits of banks.

On the whole money supply in the Indian Union averaged well below Rs. 2,000 crores in the First Plan years but has shot up to Rs. 2,400 crores in the Second Plan period. In the pre-Plan years the highest point was reached in the second quarter of 1948 when for undivided India total money supply touched Rs. 2,364 crores (May 1948). Thus in about 9 years between 1939 and 1948 money supply went up by more than five times.<sup>2</sup> Since 1952-53 the amount of money in circulation in the Indian Union has steadily increased and reached the figure of Rs. 2,701 crores in March 1960. Leaving out the abnormal circumstances brought on by the war, other factors, such as increase in population, rising level of business activity, larger production and higher national income, would normally necessitate and justify a proportionate increase in money supply. But the question arises whether these factors, in addition to the needs of war, actually justify expansion of money supply to the extent that it has taken place in the last twenty years.

An increase in money supply is not only defensible but necessary if it proceeds at the rate of expansion of economic activity in the country. Variations in the size of national income broadly reflect the level of economic activity. Hence it is possible to make a very

<sup>1</sup> *Report on Currency and Finance, 1953-54*, p. 28.

<sup>2</sup> Assuming rupee coins in circulation in 1939 to be Rs. 120 crores.

rough estimate of the magnitude of the excess or otherwise of money supply with reference to annual national income. A key to a study of this nature is variations in the income velocity of money, which is found by dividing national income by money supply.<sup>1</sup> For the war and early post-war years, estimates of national income made by the *Eastern Economist* are available. Although these estimates, especially for the war period, are only rough calculations and differ substantially from the later estimates by the National Income Committee, these can be made use of for the present purpose in so far as we are concerned more about the trends and the degree of variations than about the exactness of the estimates relating to any particular year. On this basis, variations in income velocity of money in India during the years 1939-40 to 1946-47 were as in Table 21.<sup>2</sup>

TABLE 21  
CHANGES IN THE INCOME VELOCITY OF MONEY  
1939-40 TO 1946-47

| Year    | Total national<br>income<br>(in crores of<br>rupees)<br>A | Money supply<br>(in crores of<br>rupees)<br>B | Income velocity<br>of money<br>A/B |
|---------|---|---|------------------------------------|
| 1939-40 | 2321  | 532   | 4.4                                |
| 1940-41 | 2470  | 579   | 4.3                                |
| 1941-42 | 2791  | 776   | 3.6                                |
| 1942-43 | 4048  | 1198  | 3.4                                |
| 1943-44 | 5080  | 1619  | 3.1                                |
| 1944-45 | 5125  | 1922  | 2.6                                |
| 1945-46 | 5086  | 2179  | 2.3                                |
| 1946-47 | 5385  | 2197  | 2.5                                |

(Source: *Eastern Economist Annual Number*, 31st December 1948, p. 1140.)

A comparison of the figures relating to income velocity of money and the velocity of circulation of demand deposits shows that,

<sup>1</sup> Professor Angell calls this "circular velocity of money". See *Behaviour of Money*, 1936.

<sup>2</sup> The figures are for undivided India and adjusted to include Indian States.

although there is difference in the degree of the two velocities, yet there is a general uniformity in their trends, both showing a decline over the period.

TABLE 22

## VELOCITY OF CIRCULATION OF DEMAND DEPOSITS

| Year    | Average demand liabilities of scheduled banks (in crores of rupees)<br>A | Total clearing house returns (in crores of rupees)<br>B | Velocity of circulation<br>B/A |
|---------|--|---|--------------------------------|
| 1939-40 | 132.64   | 2252.91   | 16.9                           |
| 1940-41 | 155.79   | 2071.60   | 13.3                           |
| 1941-42 | 200.13   | 2666.34   | 13.3                           |
| 1942-43 | 306.28   | 2979.09   | 9.7                            |
| 1943-44 | 456.63   | 4579.22   | 10.3                           |
| 1944-45 | 584.80   | 5626.80   | 9.6                            |
| 1945-46 | 654.53   | 6572.37   | 10.4                           |
| 1946-47 | 725.54   | 7221.38   | 9.9                            |

It may be seen from Table 21 that the income velocity of money steadily declined during the war period from 4.4 in 1939-40 to 2.3 in 1945-46, i.e. by more than 50 per cent. The income velocity of 4.4 in 1939-40 indicates that people and business firms as a whole chose to hold at any one time enough money to cover about 23 per cent of their annual spendings for output. The rise of national income by 120 per cent in the war period and the decline in the income velocity of money in the same period indicate that increased spendings were financed exclusively by larger volume of money. Low velocity means that people and firms hold unusually large amounts of money relative to their spendings. This was the natural consequence of the circumstances in war times when economic controls and other regulations combined with a feeling of insecurity on the part of the people restricted private spending. The volume

of idle balances can be roughly estimated by calculating the amount of money that would be required in each year to finance national income if velocity remained at the 1939-40 level.

TABLE 23  
ESTIMATE OF IDLE BALANCES

(In crores of rupees)

| Year    | Actual money supply | Amount of money that would have been required to finance national income with velocity at 1939-40 level | Amount of idle balance |
|---------|---------------------|---|------------------------|
|         | A                   | B   | A-B                    |
| 1939-40 | 532                 | 532   | —                      |
| 1940-41 | 579                 | 561   | 18                     |
| 1941-42 | 776                 | 634   | 142                    |
| 1942-43 | 1198                | 920   | 278                    |
| 1943-44 | 1619                | 1155  | 464                    |
| 1944-45 | 1922                | 1165  | 757                    |
| 1945-46 | 2179                | 1156  | 1023                   |
| 1946-47 | 2197                | 1224  | 973                    |

Column B is computed by dividing national income during the period by the income velocity in 1939-40. Figures in the next column would show that the volume of excess money supply was steadily increasing between the years 1942-43 and 1945-46. The average amount of estimated idle balances per year in this period was about Rs. 700 crores. This is only the reverse of the picture depicting variations in the income velocity of money, for it is obvious that given the volume of money supply, decrease in velocity of circulation means increase in idle balances and *vice versa*.

Table 24 gives National Income figures and income velocity of money for the years subsequent to 1949-50. Since the estimates made by the government are different from the national income figures calculated by the *Eastern Economist* (the latter being lower



substantially), the two sets of figures relating to income velocity of money in Tables 21 and 24 are not comparable.

TABLE 24

NATIONAL INCOME AND INCOME VELOCITY OF MONEY  
(1950-60)

| <i>Year</i> | <i>Total national income<br/>(In crores of rupees)<br/>A</i> | <i>Money supply<br/>(In crores of rupees)<br/>B</i> | <i>Income velocity of money<br/>A/B</i> | <i>Velocity of circulation of demand deposits</i> |
|-------------|--|---|---|---|
| 1949-50     | 9010   | 1861  | 4.8                                     | 10.4  |
| 1950-51     | 9530   | 1979  | 4.8                                     | 11.1  |
| 1951-52     | 9970   | 1804  | 5.5                                     | 13.3  |
| 1952-53     | 9820   | 1765  | 5.6                                     | 12.0  |
| 1953-54     | 10480  | 1794  | 5.8                                     | 12.8  |
| 1954-55     | 9610   | 1921  | 5.2                                     | 12.1  |
| 1955-56     | 9980   | 2184  | 4.6                                     | 11.9  |
| 1956-57     | 11310  | 2313  | 4.9                                     | 11.7  |
| 1957-58     | 11400  | 2389  | 4.9                                     | 11.8  |
| 1958-59     | 12470*   | 2498  | 5.0                                     | 12.9  |
| 1959-60     |  | 2701  | ..                                      | 13.4  |

\* Preliminary.

Between 1950-51 and 1953-54 national income increased by 10 per cent while money supply decreased by 10 per cent. This is reflected in the income velocity of money which went up by 21 per cent. In the same period velocity of circulation of demand deposits rose from 11 to 13. This would suggest that even as in the war period larger spendings were financed by increased money supply, in the years covered by the First Five Year Plan, increased spendings were financed by higher income velocity of money. If money supply and income velocity of money in the two years immediately preceding the First Plan period were assumed to be

normal, it would mean that in the first three years of the First Plan money supply was inadequate to meet the needs of a higher level of economic activity generated by larger investments. Viewed in this manner the marked increase in money supply in the last two years of the plan appears to be justified by the requirements of the economy. On the other hand, the increase in national income and in money supply since the commencement of the Second Plan period, attended with a steady rise both in income velocity of money as well as velocity of circulation of demand deposits would indicate that the rise in prices that has occurred in these years was due more to the rapidly rising level of spendings than to the increase in money supply. Variations in money supply as such may then be presumed to have played a passive or neutral role in the matter of price trends.

This, however, cannot be said of the earlier years of our study. The disproportionate increase in money supply as compared with the rise in price level in the war years and early post-war years (shown in Chart V) augmented the purchasing power in the hands of the public and did constitute a source of inflationary pressure in the economy. The steeper rise of the money supply curve between 1940-41 and 1945-46 in comparison with the price indices curve would indicate the magnitude of this pressure. The bulge between the two curves steadily widens up to the end of the war, becoming very conspicuous during the last three years 1943-44 to 1945-46. The official view at that time was that increased hoarding activity of the public and higher liquidity preference accounted for the large absorption of money during this period with the result that expansion of money supply had only negligible effect on prices. On the other hand, it was claimed that rise in prices combined with increased hoarding demand necessitated the putting into circulation of larger and larger volumes of money. It may, however, be mentioned that had monetary expansion been moderate demand for money would have been met by a faster turn over of money and the velocity of circulation of money would not have declined as it did in these years. That there was considerable hoarding activity during the first two or three years of war cannot be disputed. This is indicated by a series of factors, such as fall in the velocity of circulation of demand deposits<sup>1</sup> and currency, large absorption of rupee and small coins, increased demand for high denomination notes, distortion

<sup>1</sup> That is, a decline in the ratio of total cheque clearing to bank deposits.

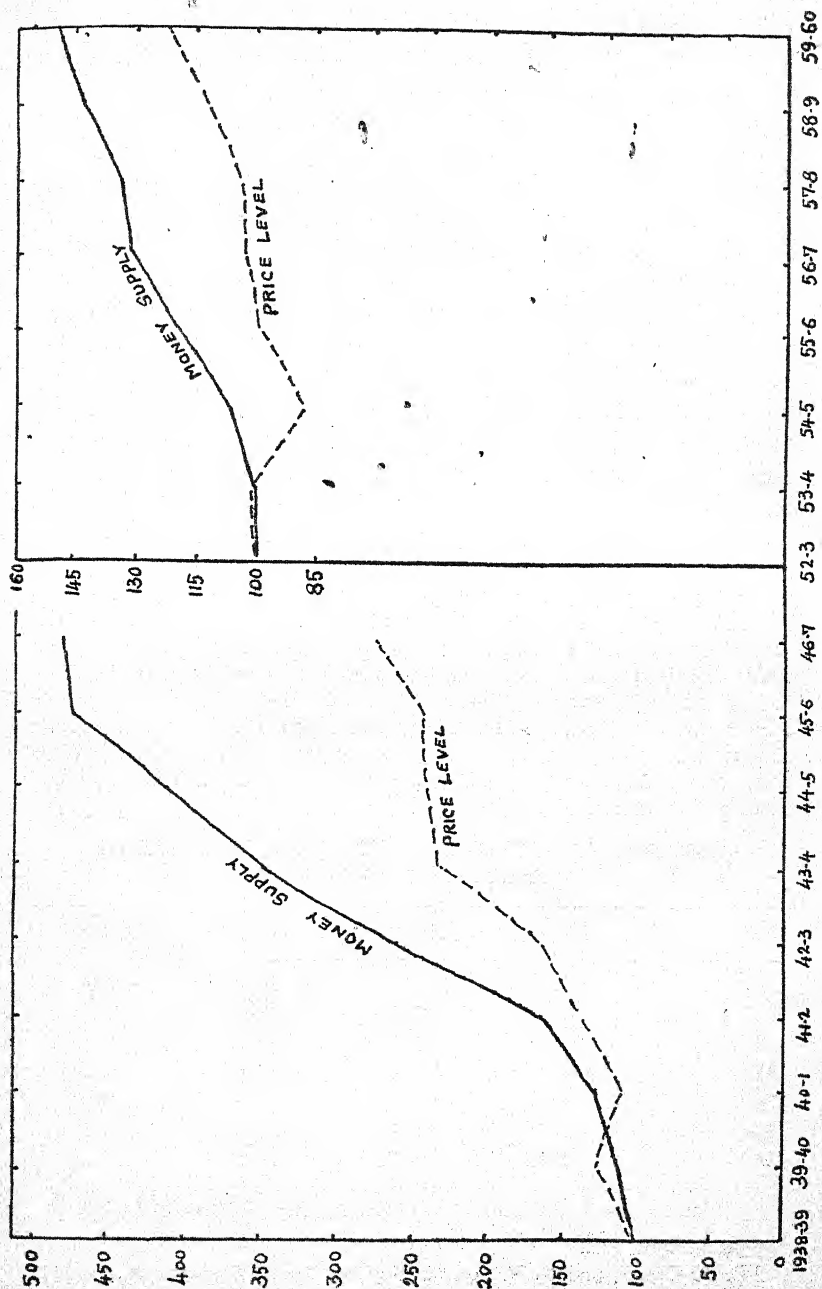


Chart V: Indices of Money Supply and Prices, 1938-39 to 1946-47 and 1952-53 to 1959-60.

in the pattern of seasonal absorption of currency,<sup>1</sup> etc. But to say that hoarding of money neutralized the effect of increased money supply on prices is to exaggerate the significance of this factor out of all proportions. The fact that the average amount of money per family increased from Rs. 68 in 1940 to Rs. 266 in 1945 while business activity and volume of production did not increase to a corresponding extent<sup>2</sup> only indicates that on the average a family at the end of the war held more money than was necessary for current transaction requirements. An abnormal increase in the supply of money and the rise in prices would by themselves increase cash holdings of the people and lower the velocity of circulation of money. At any rate, the fact that money rates in the market showed a tendency to decline in this period and that on the whole easy conditions prevailed in the money markets of the country would indicate that cash holding was not of such a magnitude as to absorb all excess money.<sup>3</sup> In reality, money supply was more than what was needed

<sup>1</sup> Failure of currency to return or net absorption in the slack season is considered as an index of hoarding activity. Similarly, the larger demand for high denomination notes in relation to the demand for notes of lower denominations is also explained by demand on account of hoarding or black marketing. See, for example, "Currency in Circulation" by G. L. Black, *Federal Reserve Bulletin*, April 1944, pp. 318-328. It has been shown earlier that the absorption and return of currency in India during the war period did not conform to the normal seasonal pattern (see p. 82). Increased demand for large denomination notes in the war period is shown below:

PERCENTAGE OF GROSS CIRCULATION OF NOTES OF  
DIFFERENT DENOMINATIONS

| Year | Rs. 5 | Rs. 10 | Rs. 100 | Rs. 1,000 |
|------|-------|--------|---------|-----------|
| 1939 | 19.4  | 41.9   | 32.1    | 5.9       |
| 1940 | 18.3  | 40.6   | 33.4    | 7.3       |
| 1941 | 18.3  | 39.7   | 33.3    | 8.3       |
| 1942 | 18.3  | 37.4   | 34.8    | 9.3       |
| 1943 | 17.1  | 36.3   | 34.9    | 10.9      |
| 1944 | 14.8  | 36.1   | 38.0    | 10.1      |
| 1945 | 12.8  | 35.3   | 41.2    | 9.4       |

(Source: *Reports on Currency and Finance*, Reserve Bank of India.)

<sup>2</sup> See Chapter VIII.

<sup>3</sup> D. R. Gadgil, and N. V. Sovani, *War and Indian Economic Policy*, 1943, pp. 40, 41.

to satisfy the hoarding needs as they existed and the requirements of currency transactions. The steep rise in prices between 1941 and 1943 has therefore to be attributed to a large extent to monetary expansion. Since 1943 till the end of the war, although money supply increased at a high rate, prices were on the whole stable, mostly because of the effective control policy of the government. But the latent pressure of too much money was there, only to manifest itself after 1945-46. In the years immediately following the close of hostilities, although rise in money supply was arrested, relaxation of controls and the removal of restrictions on the private sector of business brought into play the pent up pressure of excessive money supply which had been accumulating in the previous few years.

Since 1949-50, both money supply and prices have fluctuated considerably, and the former has at times taken the lead. The volume of money with the public declined sharply in 1951-52 and to a small extent in the next year; price level continued to rise till 1951-52, but in the next year receded at a faster rate than money supply. Since 1952-53 money supply has steadily increased with a rapid rise in the rate of increase. The downtrend in prices between 1953-54 and 1955-56 as against a rise in the volume of money has to be ascribed mostly to favourable domestic supply conditions. Between 1955-56 and April 1960, the supply of money with the public went up from Rs. 2,184 crores to Rs. 2,744 crores or by 25 per cent while price level rose by about 22 per cent. For reasons mentioned earlier this close parallelism between the movements of the volume of money and price level should not lead to any conclusion about any cause and effect relationship between money supply and prices during this period.



## CHAPTER V

### WAR FINANCE AND INFLATION

SPENDING for purposes of investment as well as for consumption results in the activation of money. The level of spending determines the size of money income and the volume of purchasing power in the hands of the people. It is obvious that the level of prices in a country can be pushed up or brought down by the extent to which purchasing power of the community is utilized actively or kept idle. This explains the preponderant part played by government's budgetary policy in the determination of price level. Even in countries which do not generally approve of any rapid extension of government's activities, the size of public expenditure is rapidly increasing. The extent to which government's activities relating to the collection of revenue and the spending of it can affect the economy of the country and the general level of prices may be known from the fact that in our country during the last few years the expenditure of the Central and State Governments has constituted more than a tenth of the national income. The influence of such an agency responsible for the absorption and releasing of such a large volume of funds annually in determining price level in a country is thus patent.

However, the magnitude of government's spending only indicates its potentiality in the determination of the country's price structure. Normally, when the government's absorption of funds through taxation and borrowing is equivalent to its release of funds by its various expenditure programmes, budgetary policy cannot have any net effect on price position in the country. Its effect is then neutral. It thus logically follows that when the government's budget is not balanced, i.e. when government releases more funds than it absorbs or *vice versa*, price level will be affected. Thus strictly speaking it is the size of the surplus or deficit in the national budget that has any significance in an investigation of the development of inflationary or deflationary tendencies. But this should not lead one to underestimate the effect of government's spending activity on the national economy as such. What is meant here is that balanced budgets cannot influence prices in the same way as a deficit or surplus budget can.

An inflationary trend in prices is quite often associated with budget deficits. Usually, an excess of government's spendings over its receipts occurs during a period of war or when the government has launched upon a large scale investment programme leading to a planned economic development of the country. Till recently, orthodox public finance did not eye with favour the technique of deficit financing as a means to economic development. On the other hand, circumstances of war necessitated and justified government's spending much beyond its resources and thus deficit finance became nearly synonymous with war finance and inflation.

The crucial problem in a period of war is obviously for the government to find enough resources for the successful prosecution of the war operations. In other words, government should find by some means or other the necessary funds and through it secure adequate resources in men and materials for purposes of fighting. But short of commandeering of the resources, which is not possible in a normal democratic set-up, the government has to enter the market and secure the resources that it requires by bidding against civilian demand. This means that government should have enough of money to command the resources in the market. If it then attempts to secure more funds by resorting to the crude method of using the printing press for issuing more currency notes, the outcome will be an immediate release of an inflationary pressure. This is aggravated by two forces. Firstly, with every absorption of resources by the State the stock of consumption and production goods needed for civilians steadily decreases. Secondly, this would by itself boost up prices and as prices go up government would have to issue more and more money. Thus a vicious inflationary spiral is set in motion which gathers momentum at each turn.

The destructiveness of modern wars is paralleled only by their huge cost. Of the total expenditure of \$310 billion of the Federal Government of the U.S.A. in 1942-45, \$280 billion was for war purposes. The First World War cost U.S.A. \$30 billion and the Second ten times as much. The annual outlay on the Second World War represented about 40 per cent of the national product of the U.S.A. and about 50 per cent of the national product of Great Britain. The total expenditure incurred by the United Kingdom during the years 1939-45 was more than £25,000 million.<sup>1</sup> Financial cost of these dimensions cannot be met out of the ordinary revenue

<sup>1</sup> British White Paper on War Finance, *Federal Reserve Bulletin*, July 1946.

resources of the State. Public revenue collected by means of taxation forms only a very small proportion of the total cost incurred on account of war. Introduction of new taxes and the raising of the rates of existing ones succeed in securing only a small proportion of the additional money income created by war factors. The yield of the taxes fails to increase in proportion to the rise in prices. Thus in India between 1938-39 and 1945-46, while total outlay of the Central Government increased by more than ten times, tax revenue increased only by about four times.<sup>1</sup> Thus the gap between the ordinary receipts of the State and its expenditure in the period of war steadily and rapidly widens. This difference, however, does not represent an exact measure of the inflationary potential created by war factors. For the fact remains that the entire deficit has somehow to be covered, and part of it at least is actually covered by means which do not add to the inflationary pressure.

A budgetary deficit may be covered, apart from the direct issue of currency notes by the government, by borrowing from the central bank, from the commercial banks and from the public. Government borrows from the central bank by transferring instruments of debt, such as Treasury Bills to the latter and by creating a deposit in favour of the government. To meet that portion of the expenditure which is not covered by taxation, the government draws down these deposit accounts. Payment is then made by the government to contractors, suppliers of materials and others by drawing cheques on this deposit. In consequence, the individual deposits with the commercial banks increase, while after clearance the reserves of commercial banks with the central bank also increase to the same extent that the government deposits with the central bank decrease. This increase in bank reserves makes possible a multiple increase in bank loans and deposits. Budget deficit covered in this way generates inflationary effects in two ways: firstly, via the multiplier resulting from increased government spending; secondly, by the cheapening of bank credit through the increase in bank reserves. If the government resorts to borrowing from the commercial banks, the effect is very much the same. Nevertheless, its effects on money supply may not be so expansionary as in the first case, for, while commercial banks release to the government when the latter borrows from them

<sup>1</sup> Outlay of the Central Government went up from Rs. 85 crores to Rs. 894 crores, while tax revenue increased from Rs. 76 crores to Rs. 311 crores.

only the additional deposits that they receive, in the case of the former there is a greater pyramiding effect in so far as the amount borrowed from the central bank and spent by the government enlarges the cash basis of the commercial banks. Increase in their deposits with the central bank will have a greater expansionary effect on credit than when they subscribe to government loans out of their increased deposits. Essentially, however, financing of a deficit by these two methods is equivalent in effect to issue of more currency notes directly by the government with this difference that, while in the case of borrowing from the central bank and commercial banks government's interest-bearing debt is increased, in the case of outright creation of currency government does not incur any additional interest-bearing obligation.<sup>1</sup> The third way of financing the deficit is by borrowing from the public. This results in the absorption of spendable income from the community and is in its nature and effects similar to taxation except that it is not compulsory. It is likely that some of the money utilized by individuals in purchasing government securities would otherwise have been spent by them for the purchase of goods and services. To the extent that this method of deficit financing results in the neutralization of purchasing power of the community or helps in substituting government expenditure in the place of private expenditure, its effects may be deemed to be on the whole non-inflationary.

Of the three methods indicated above, the first is more inflationary than the second, and the second more inflationary than the third. In general, the best way of financing a budget deficit without creating any large inflationary potential is by borrowing from individuals. Nevertheless, it is not possible to consider this method as one without any inflationary possibility at all. Its inflationary effect is nil only when public subscription to loans comes out of the savings from current income. On the other hand, if in order to subscribe to government loans individuals and non-financing institutions draw upon their accumulated savings or get advances from banks against their fixed deposits or other securities, there will not be any reduction in current purchasing power of the community but only an addition to the inflationary pressure in so far as such a process represents an activation of idle money.

<sup>1</sup> Allen, Buchanan and Colberg, *Prices, Income and Public Policy*, McGraw Hill, 1954, p. 266.



*The Nature of War Finance*

The inflationary effect of war finance in India originated mostly from the peculiar situation created by the financial agreement between the Government of India and the British Government. As a result of this agreement, the Government of India was spending large sums of money not only on its own account but also on account of the allied governments. In reality, the size of the expenditure incurred on account of the British Government was out of all proportion to India Government's own expenditure. According to the agreement of November 1939, the whole of the defence expenditure incurred by the Government of India was to be apportioned between the two governments as follows:

India was to bear

- (1) a fixed annual sum representing the normal net effective costs on the Army in India under peace conditions, plus
- (2) an addition to allow for rise in prices, plus
- (3) the cost of such war measures as could be regarded as purely Indian liabilities by reason of their having been undertaken by India in her own interest, and
- (4) a lump sum payment of one crore of rupees towards the extra cost of maintaining India's External Defence Troops overseas.

The British Government was to bear the total amount by which the net annual defence expenditure incurred in India during the war years would exceed the aggregate of the first three items.<sup>1</sup> This came to be known as the recoverable war expenditure of the Government of India.

Of the above four items, item (1) was fixed at Rs. 36.77 crores for the duration of the war. This figure was arrived at by deducting from the budget estimate for defence services for 1939-40 of Rs. 45.18 crores a sum of Rs. 8.41 crores, being the non-effective charges. Item (2) varied and was calculated for each year with reference to price changes from time to time in consultation with the Economic Adviser to the Government of India. Item (3) represented India's share of the financial burden of the war, and item (4) was included in the settlement in pursuance of the principle

<sup>1</sup> Finance Member's Budget Speech, 1940-41.



of India's joint responsibility for her external defence on the basis of the Chatfield Settlement. According to this principle, the defence expenditure of the Government of India, both revenue and capital, during the war period was as shown in Table 25.

TABLE 25  
DEFENCE EXPENDITURE OF THE GOVERNMENT  
OF INDIA DURING WAR  
(In crores of rupees)

|                                | 1939-40 | 1940-41 | 1941-42 | 1942-43 | 1943-44 | 1944-45 | 1945-46 |
|--------------------------------|---------|---------|---------|---------|---------|---------|---------|
| <i>On Revenue Account</i>      |         |         |         |         |         |         |         |
| 1. Normal basic budget         | 36.77   | 36.77   | 36.77   | 36.77   | 36.77   | 36.77   | 360.23  |
| 2. Rise in prices              | 1.19    | 2.57    | 4.39    | 7.97    | 14.44   | 18.73   |         |
| 3. War measures (net)          | 3.52    | 25.90   | 54.44   | 161.63  | 298.75  | 330.61  |         |
| 4. Non-effective charges (net) | 8.07    | 8.38    | 8.33    | 8.26    | 8.44    | 9.38    |         |
| <i>On Capital Account</i>      | —       | —       | —       | 52.51   | 37.46   | 62.83   | 35.09   |
| Total                          | 49.54   | 73.61   | 103.93  | 267.13  | 395.86  | 458.32  | 395.32  |

(Source: *Report on Currency and Finance, 1946-47*, Reserve Bank of India.)

The recoverable expenditure of the Government of India during war years was as large as the war expenditure incurred on her own account. This is shown in Table 26.

TABLE 26  
TOTAL MILITARY EXPENDITURE OF THE GOVERNMENT OF  
INDIA DURING WAR  
(In crores of rupees)

| Year                     | Defence expenditure on India's account | Recoverable war expenditure | Total of 1 and 2 |
|--------------------------|--|-----------------------------|------------------|
|                          | 1                                      | 2                           | 3                |
| 1939-40                  | 49.54                                  | 4.00                        | 53.54            |
| 1940-41                  | 73.61                                  | 53.00                       | 126.61           |
| 1941-42                  | 103.93                                 | 194.00                      | 297.93           |
| 1942-43                  | 267.13                                 | 325.48                      | 592.61           |
| 1943-44                  | 395.86                                 | 377.87                      | 773.73           |
| 1944-45                  | 458.32                                 | 410.84                      | 869.16           |
| 1945-46                  | 395.32                                 | 374.54                      | 769.86           |
| Total 1939-40 to 1945-46 | 1743.71                                | 1739.73                     | 3483.44          |

(Source: *Report on Currency and Finance, 1946-47*, Reserve Bank of India.)

The inflationary effect of the budgetary deficits arising out of the increased defence expenditure on Government of India's account was moderate in so far as these deficits were more than covered by increased taxation and borrowing. On the other hand, the financing of the huge military expenditure incurred on account of the British Government led to an unprecedented expansion of currency which helped in the pushing up of prices. This was the direct consequence of the arrangement made by the India Government for the meeting of the military expenditure of the allied governments. It should be remembered that, although this expenditure could eventually be recovered in sterling from the British Government, it was first to be incurred by the Government of India in rupees. Payment for expenditure on behalf of the British Government was made to India in sterling and held by the Government of India in the form of Treasury Bills. The United States' purchases in India were paid for in dollars to the British Government which offered the equivalent in sterling to India Government. Thus, as the expenditure in India on behalf of the allied governments increased, her holding of sterling also correspondingly increased. Since sterling forms one of the assets of the Reserve Bank of India which can be used as cover for the issue of rupee notes, the Government of India made use of this provision to make payments in India in rupee by exchanging its sterling assets to the Reserve Bank of India for rupees. The sterling received from the Government of India by the Reserve Bank would first be reflected in the Banking Department as an addition to the "balances held abroad" on the assets side with a corresponding increase in government deposits on the liabilities side. The government would then draw cheques on this deposit in favour of parties in India to whom it had to make payments. These would then send the government cheques to the credit of their accounts with the commercial banks. The latter in their turn would pass on the cheques to the credit of their balances with the Reserve Bank. The net result of these transactions would therefore be a fall in the deposits of the government with the Reserve Bank and an increase in the deposits of commercial banks with the Reserve Bank. When in the next step government as well as the parties who received cheques from the government and who deposited these cheques with their banks began to draw cash, there would be a fall in the cash holdings of the commercial banks accompanied by a reduction in the portfolio of cash

with the Banking Department of the Reserve Bank. As the amount of cash, namely notes and rupees, in the Banking Department tended to fall below the customary level, the Reserve Bank would transfer a part of the sterling securities or "balances held abroad" from the Banking Department to the Issue Department and on the basis of this asset would replenish the till of cash by issuing new notes. The result would then be an increase on the liabilities side of the Issue Department under "notes held in the banking department" and/or the "notes in circulation" if paid out, as the case may be, against a corresponding addition to sterling securities on the assets side. In this manner, the acquisition of sterling securities by the Government of India as a result of expenditure incurred on behalf of the allied governments led to an expansion in the volume of currency in the country. The figures in Table 27 bring out the relationship between the increase in the recoverable war expenditure and sterling holdings on the one hand and between the latter and notes in circulation on the other.

TABLE 27  
WAR EXPENDITURE AND THE INCREASE IN NOTE  
CIRCULATION

(In crores of rupees)

| Year    | Recoverable war<br>expenditure | Increase in<br>sterling securities | Increase in notes<br>in circulation |
|---------|--------------------------------|------------------------------------|-------------------------------------|
| 1941-42 | 194.00                         | 35.08                              | 73.09                               |
| 1942-43 | 325.48                         | 154.11                             | 185.56                              |
| 1943-44 | 377.87                         | 324.41                             | 263.73                              |
| 1944-45 | 410.84                         | 220.21                             | 191.52                              |
| 1945-46 | 374.54                         | 197.53                             | 193.95                              |

(Source: *Report on Currency and Finance*, Reserve Bank of India, 1946-47.)

It should be observed that during these years, the other assets of the Issue Department—gold coin and bullion, rupee coin and rupee securities—did not show any great variation. The close relationship between the increase in sterling securities and the volume of notes in circulation is thus obvious enough.

The size of the budgetary deficit which is of considerable significance in any study relating to war-time inflation is represented

by the difference between the over-all disbursements of the Government of India including recoverable war expenditure on the one hand and the receipts of the government on the other. The foregoing analysis makes it clear that the tendency for expansion of currency in the war period could have been checked or retarded only if government receipts through taxation as well as borrowing were made to increase in proportion to the scale of government disbursements on all accounts. To the extent the deficit was covered by additional taxation and borrowing, the inflationary gap became narrower. In the circumstances of the times, reduction in the scale of government expenditure was out of the question. And soon the inflationary effect of the technique of war finance adopted by the government had become patent and government policy came in for sharp criticism. However, looking back on those wartime arrangements, especially against the background of the political relationship and the economic situation in the country, some of the suggestions made by the critics of the government for controlling inflationary trends in the country appear quite impracticable. One of the measures recommended was the floating of a rupee loan in India by Britain. As would be shown presently, the government resorted to borrowing on a substantial scale to cover part at least of the deficit. But in the final analysis, the effect of expansion of currency or increased taxation and borrowing would only be the withdrawing of a large proportion of current output from public consumption for war purposes. The scope for further borrowing was obviously limited in view of the fact that the bulk of the population has been living on the margin of subsistence. Another alternative suggested, namely, the raising of the interest rate on government loans to attract more funds, was ruled out by the government for the above reason as well as on the ground that it would, apart from raising the interest burden of debt, handicap industrial expansion in the post-war period. It was thus argued by government representatives that, in so far as further taxation and borrowing was impossible and reduction in the scale of government expenditure out of the question, the only choice left to the government was to resort to expansion of currency. So long as the total size and volume of resources to be withdrawn for war purposes from public consumption was fixed, if currency were not expanded against sterling, the alternative was to expand it against borrowing from the Reserve Bank. And government found satisfaction in



the fact that they had not been forced into the last method of financing the deficit.

*Tax Policy in the War Period*

We have seen that of the total disbursements of the Government of India on all accounts, that portion represented by recoverable war expenditure was met almost entirely by the issue of currency on the backing of sterling securities. But apart from the expenditure on this account, Government of India's own defence expenditure and civil expenditure increased rapidly during the war period. The total expenditure of the Government of India on its account increased from Rs. 85.15 crores in 1938-39 to Rs. 559.54 crores in 1945-46 or by more than six times. This expansion on the expenditure side of the budget was met partly by taxation and partly by borrowing. The revenues of the government increased as a result of the imposition of new taxes and additions to the rates of existing taxes. But the additional revenue obtained by this means was not adequate to meet the rapidly increasing expenditure of the government and as a consequence the government had to meet with deficit budgets. Nevertheless, this deficit, although of a considerable magnitude, did not cause any inflationary gap because government was able to collect large sums of money from the public by its loan policy, so that the receipts on account of borrowing and taxation more than covered the budget deficits.

Although government was slow to admit the inflationary effect of allied expenditure in India, yet even in the first year of the war the need for closing the budget deficit by means of taxation and borrowing was stressed. It is, however, worth remembering that taxation, at least till the closing years of the war, was made use of only as a means of meeting increasing expenditure. Although this would have had some anti-inflationary effect, yet its significance as an anti-inflationary method of financing government expenditure was considered only at the later stages of the war.<sup>1</sup> A review of the budget proposals for the war years would make it clear that, in general, government's intention was to cover one-third to one-half of the budgetary deficit by means of taxation and the rest by means of borrowing. In actual fact, however, new levies and the substantial additions to the rates of existing taxes did not bring

<sup>1</sup> Finance Member's Budget Speech, 1944-45.



in as large revenues as had been anticipated, so much so that actual deficits were uniformly much above what had been figured out in the budget estimates and hence reliance had to be placed to a greater and greater extent on borrowing for financing budget deficits.

The extent to which taxation was made use of by the Central Government to meet the increasing public expenditure, and the nature of the levies are brought out in the following statement:

*Changes in the Tax Structure during the War Period*

- |         |   |  |
|---------|---|--|
| 1940-41 | { | <ol style="list-style-type: none"> <li>1. Excess Profits Tax—Rate 50 per cent of the excess profits over “standard profits”.</li> <li>2. Excise duty on sugar raised from Rs. 2 to Rs. 3 per cwt.</li> <li>3. Duty on motor spirit raised from 10 annas to 12 annas a gallon.</li> </ol>   |
| 1941-42 | { | <ol style="list-style-type: none"> <li>1. Rate of Excess Profits Tax raised to 66<math>\frac{2}{3}</math> per cent.</li> <li>2. The Central surcharge of 25 per cent on income-tax and super tax raised to 33<math>\frac{1}{3}</math> per cent.</li> <li>3. Excise duty on matches doubled.</li> <li>4. Specific import duty on artificial silk and yarn raised from 3 annas to 5 annas per pound.</li> <li>5. New excise duty of 10 per cent <i>ad valorem</i> on pneumatic tyres and tubes.</li> </ol> |
| 1942-43 | { | <ol style="list-style-type: none"> <li>1. Slight raising of income-tax surcharges on certain groups of income.</li> <li>2. Emergency surcharge over the whole field of import duties equal to 20 per cent of those duties.</li> <li>3. Excise duty on motor spirit raised by 3 annas with a like automatic rise in import duty.</li> <li>4. Excise duties on kerosene and silver made equal to the import duties.</li> <li>5. Increase in posts and telegraphs rates.</li> </ol>                         |
| 1943-44 | { | <ol style="list-style-type: none"> <li>1. Surcharge on income-tax raised. Rate of super-tax and corporation tax also enhanced.</li> <li>2. New Central excise duty on tobacco imposed.</li> <li>3. Excise duty of Rs. 7 per cwt. on vegetable products (vanaspati).</li> <li>4. Further increase in posts and telegraphs rates.</li> </ol>   |

- 1944-45
1. Central surcharge on income-tax further raised; also rise in super tax and corporation tax rates.
  2. Emergency surcharge of 20 per cent of the basic customs duties raised to 50 per cent for tobacco and spirits.
  3. Excise duty on tobacco enhanced.
  4. Excise duty of 2 annas a pound on betelnuts, coffee and tea.

Between 1938-39 and 1945-46, while Central Government's expenditure on India's account rose by more than six times, the total tax revenue increased only by four times. The disparity between the rate of increase in tax yield and the increase in expenditure would show that as the war progressed taxation was able to absorb a lesser and lesser volume of the additional purchasing power released by public expenditure. But apart from this failure of the tax means to absorb a much larger proportion of purchasing power from the public, the fact remains that the type of taxes chosen by the government were of doubtful value to attain the objective of neutralizing the inflationary effects of the government's outlay. It has been argued that unless taxation increases more than government expenditure, it would not completely avoid inflation. This is because of the fact that the impact on spending of any increase in taxation will be cushioned by a decline in saving.<sup>1</sup> It is obvious that this theoretical ideal of surplus tax revenues cannot easily be attained. But, short of this, it may be laid down as a broad principle that taxation as an anti-inflationary means would be successful to the extent that it diverts purchasing power from being utilized for consumption expenditure. In reality, owing to the circumstances brought on by the war, a large volume of funds went into hoards and formed themselves into a powerful inflationary potential. Tax policy as adopted during the war could not ferret out this element of inflation. On the other hand, some of the methods adopted, such as increase in the rates of income-tax and supertax and also the levy of an excess profits tax, would certainly have exerted a dampening effect on saving and investment and therefore on production. Although this might not have been so dangerously deterrent to enterprise as made out by representatives of the business classes, it is plain that it would not have had any

<sup>1</sup> W. Manning Dacey, *The British Banking Mechanism*, 1951, p. 157.

great anti-inflationary effect. Furthermore, the fact remains that in a country where a large portion of the people live on the margin of subsistence so that consumption taxes have to be taxes on necessities, and where the velocity of circulation of money is low and where in vast areas of the country a market economy is not well developed, taxation as an anti-inflationary measure could have only a very limited scope.

More important as an anti-inflationary measure was the deposit scheme applicable to income-tax and excess profits tax and adopted in 1942-43. By the Finance Act of 1942, incomes between Rs. 1,500 and Rs. 2,000 were made liable to taxation at six pies in the rupee and on the excess over the first Rs. 750 of the total income. But no tax would be levied if the assessee exercised the option of depositing about  $1\frac{1}{4}$  times the amount of tax to which he would otherwise be liable in the Post Office Savings Bank account. This amount could not be withdrawn till one year after the end of the war. As the Finance Member claimed, this was in its essence a scheme of saving rather than of taxation. Similarly, in the case of excess profits tax, the government undertook in 1943 to contribute an amount up to, but not exceeding,  $\frac{1}{10}$  of the net excess profits tax ultimately paid at the rate of  $66\frac{2}{3}$  per cent, provided the assessee deposited a sum equal to double this amount, i.e.  $\frac{1}{5}$  of the net excess profits tax. Such deposits would earn simple interest at the rate of 2 per cent per annum and would be repaid within 12 months of the end of the war. The purpose of the government in this measure also was to immobilize as much of the excess profits earned during the war as possible and to prevent postponable private expenditure from exerting an undesirable influence on the price level.<sup>1</sup> In the next year, the compulsory deposit of  $\frac{1}{5}$  of the excess profits tax was raised to  $\frac{19}{64}$  of the tax, while at the same time no alteration was made in the proportion of the tax, namely,  $\frac{1}{10}$ , to be repaid by government to the assessee. This, it was claimed, would immobilize as deposits the whole of the excess profits remaining after payment of excess profits tax as also the income-tax and super tax.<sup>2</sup> It was hoped that the recovery by this means of a substantial portion of the business earnings during the war period would, besides acting as an anti-inflationary measure, afford after the end of the war means for fresh investment.

<sup>1</sup> Finance Member's Budget Speech, 1942-43.

<sup>2</sup> Finance Member's Budget Speech, 1944-45.

To the same category of anti-inflationary devices would also belong the scheme for the advance payments of tax on income not deductible at source, introduced in 1944-45.

### *Borrowing Policy in the War Period*

The need for borrowing as a means of neutralizing the increased purchasing power was realized at a sufficiently early stage of the war. While in the first year of the war the budgetary gap was closed by increased taxation and to some extent by applying Rs. 91 lakhs surplus in the Revenue Reserve Fund, in all the subsequent years government came to depend more and more upon borrowing from the public. In introducing the budget for 1941-42 the Finance Member emphasized the desirability of an intensive mobilization of the country's savings if India's war effort was to be financed in the most satisfactory way. This need was again and again stressed and it was repeatedly pointed out that in the context of war, absorption by means of borrowing of increased purchasing power, inevitably caused by war finance, would, besides furnishing the necessary resources for government, also help in keeping down prices and in facilitating economic reconstruction and development after the end of hostilities. In the words of Sir A. J. Raisman, public loan in the context of a war economy is "twice blessed; it blesseth him that gives and him that takes. To the State it spells an indispensable aid to victory, while to the investor it means not only a precaution against the perils and uncertainties of the transition from war to peace after victory has been gained, but also a potent preventive against the economic and social disorder which may arise from the uncontrolled exercise of purchasing power in relation to limited or diminishing stocks of consumable goods."<sup>1</sup>

It was in accordance with this objective that various loans were floated and other measures were adopted suitable for encouraging popular savings and absorbing large amounts from the lower and middle strata of society. Within a year of the outbreak of the war, government started the Defence Savings Movement with the issue of the 3 per cent Six Year Defence Bonds in June 1940. This was followed up in subsequent years by the Second, Third and Fourth Defence Loans in 1941 to 1943 and the two 3 per cent Victory Loans issued in 1944 and 1945. Most of these loans were short or medium

<sup>1</sup> Finance Member's Budget Speech, 1943-44.



term and were raised on a 3 per cent basis. The increase in the maturity of the later issues meant in effect a lowering of the effective rate of interest. The success of government's cheap money policy is also further exemplified by the issue of Treasury Bills whose volume steadily increased up to 1943 with a simultaneous decline in their average rate from 1.63 in 1938-39 to 0.49 in 1944-45, and to 0.38 in 1945-46. Apart from the Defence and Victory Loans and short term borrowing by means of Treasury Bills, government succeeded in mobilizing a large volume of small savings by providing attractive opportunities of investment for people with limited means. To the Post Office Five Year Cash Certificates dating from 1917-18 were added the Ten Year Defence Savings Certificates in 1940. The Post Office Defence Savings Bank was opened in April 1941 to collect small deposits bearing  $2\frac{1}{2}$  per cent interest free of income-tax and repayable after the end of the war. Twelve Year National Savings Certificates were issued in October 1943 with a more attractive rate of interest. At the same time, the rate of interest on Post Office Savings Bank Deposits was raised from  $1\frac{1}{2}$  to 2 per cent on balances not falling below Rs. 200. In all, small savings accounted for more than Rs. 220 crores in 1945-46 and formed 10.1 per cent of the total debt of the government.<sup>1</sup>

These loans were at first well received by the public, but by 1943 it appeared that the initial momentum was being lost. To a large extent this was due to the fact that a substantial portion of the additional purchasing power released by the government had got into the hands of certain sections of the population not accustomed to the investment habit. To some extent purchasing power was recovered from this source by the sale of gold by the Reserve Bank of India provided by the Governments of the U.K. and the U.S.A. to meet part of their war expenditure in India. Such sales, however, began only in 1943-44 and over the three years, 1943-44 to 1945-46, amounted to only 7.5 million ounces.<sup>2</sup> At rates varying between Rs. 62 and Rs. 75-6-0 per tola,<sup>3</sup> the total rupee value would be about Rs. 125 crores. In addition, the repatriation of sterling debt by the issue of rupee counterparts in India which commenced from 1937-38 also helped in the absorption of surplus money from the public. Between 1937-38 and 1945-46 the rupee counterparts

<sup>1</sup> R. N. Poduval, *Finance of the India Government*, 1951, p. 110.

<sup>2</sup> Reserve Bank of India, *Report on Currency and Finance*, 1945-46, p. 35.

<sup>3</sup> 1 oz =  $2\frac{1}{2}$  tolas.



created against repatriated sterling debt amounted to Rs. 274 crores. Of this Rs. 219 crores, or more than three-fourths, were held by the public and the banks.

The net result of the borrowing policy of the government during the war period is shown in Table 28.

TABLE 28

### INTEREST-BEARING OBLIGATIONS (IN INDIA) OF THE GOVERNMENT OF INDIA

(In crores of rupees)

| Year     | Loans   | Treasury<br>bills and<br>ways and<br>means ad-<br>vances | Unfunded<br>debt* | Deposits† | Total   |
|----------|---------|--|-------------------|-----------|---------|
| 1938-39  | 437.87  | 46.30  | 225.13            | 27.34     | 736.64  |
| 1939-40  | 450.23  | 54.70  | 222.24            | 33.47     | 760.64  |
| 1940-41  | 574.55  | 84.90  | 198.91            | 44.38     | 902.74  |
| 1941-42  | 611.85  | 136.98   | 189.14            | 60.54     | 998.51  |
| 1942-43  | 748.74  | 264.70   | 189.49            | 95.94     | 1298.87 |
| 1944-45  | 1212.14 | 86.70  | 265.63            | 258.18    | 1822.65 |
| 1945-46‡ | 1489.39 | 86.70  | 330.90            | 285.64    | 2192.63 |

\* Includes Post Office Savings Bank Deposits, Cash and Defence Savings Certificates, National Saving Certificates, State Provident Funds and other items.

† Includes Depreciation and Reserve Funds and other deposits.

‡ Revised Estimate figures.

(Source: Explanatory Memorandum of General Budget from 1939-40 onwards.)

It may be seen from Table 28 that the total interest-bearing obligations (in India) of the government increased from Rs. 736.64 crores in 1938-39 to Rs. 2,192.63 crores in 1945-46, or by Rs. 1,455.99 crores. This then represents the amount of purchasing power absorbed by the government during the war period by its loan and other measures.

TABLE 29

## PUBLIC REVENUE AND EXPENDITURE AND INFLATIONARY GAP

(In crores of rupees)

|   | 1939-40 | 1940-41 | 1941-42 | 1942-43 | 1943-44 | 1944-45 | 1945-46 | 1939-40<br>to<br>1945-46 |
|---|---------|---------|---------|---------|---------|---------|---------|--------------------------|
| 1. Revenue  | 94.57   | 107.65  | 134.57  | 176.88  | 252.06  | 335.57  | 360.67  | 1461.97                  |
| 2. Expenditure  | 94.57   | 114.18  | 147.26  | 289.05  | 441.84  | 496.71  | 484.57  | 2068.18                  |
| 3. Deficit  | —       | 6.53    | 12.69   | 112.17  | 189.78  | 161.14  | 123.90  | 606.21                   |
| 4. Aggregate outlay including recoverable war expenditure | 98.57   | 167.18  | 341.26  | 667.04  | 857.17  | 970.38  | 894.20  | 3995.80                  |
| 5. Total deficit (4-1)                                    | 4.00    | 59.53   | 206.69  | 490.16  | 605.11  | 634.81  | 533.53  | 2533.83                  |
| 6. Net increase in interest-bearing obligations           | 24.00   | 142.10  | 95.77   | 300.36  | 198.90  | 324.88  | 369.98  | 1455.99                  |
| 7. Inflationary gap (5-6)                                 | -20.00  | -82.57  | 110.92  | 189.80  | 406.21  | 309.93  | 163.55  | 1077.84                  |
| 8. Net increase in note circulation*                      | 46.14   | 15.45   | 141.18  | 261.85  | 238.91  | 202.39  | 133.89  | 1039.81                  |

\* On the basis of year-end figures.

(Source: *Reports on Currency and Finance*, Reserve Bank of India.)

The anti-inflationary effect of the loan measures adopted by the government during the war period may now be briefly indicated. Between 1939-40 and 1945-46 government expenditure on all accounts, that is, revenue and capital expenditure on India Government's account plus expenditure incurred on account of the British Government and allied governments (recoverable war expenditure), amounted to Rs. 3,995.80 crores. This represents the volume of purchasing power released to the public through the agency of government's expenditure. Of this Rs. 1,461.97 crores returned to government in the form of tax and non-tax revenue, leaving a gap of the order of Rs. 2,533.83 crores. This gap was covered to the extent of Rs. 1,455.99 crores by the non-inflationary method of borrowing from the public. The rest of the inflationary gap or Rs. 1,077.84 crores had to be covered by increasing note issue. The figures in Table 29 illustrate this point.

A reference to the figures in rows 3 and 6 would show that the deficit arising from expenditure on India Government's account was more than covered by borrowing. The net increase in the interest-bearing obligations of the government of Rs. 1,455.99 crores shows that borrowing from the public covered not only in full the deficit arising on Government of India's account but also a substantial portion of the deficit caused by recoverable war expenditure. The effective inflationary gap is indicated by the difference between the aggregate outlay on all accounts and the total receipts by way of revenue as well as borrowing. This amounted to Rs. 1,077.84 crores and was met by note issue which increased from Rs. 178.96 crores at the end of 1938-39 to Rs. 1,218.77 crores at the end of 1945-46, or by Rs. 1,039.81 crores. Thus 37 per cent of the total expenditure on all accounts during the seven years 1939-40 to 1945-46 was met by taxation, 36 per cent by borrowing and 27 per cent by expansion of currency. The gap between the aggregate expenditure, Rs. 3,995.80 crores, and receipts by way of tax and non-tax revenue and borrowing, Rs. 2,917.96 crores, i.e. Rs. 1,077.84 crores thus represents the inflationary potential of war finance in India.

## CHAPTER VI

### DEVELOPMENT FINANCE AND INFLATION

#### *Post-War Budgetary Policy, 1946-51*

FOR OBVIOUS reasons government had to face during the war period a series of budgetary deficits of an unprecedented magnitude. The annual release of large funds by the State on account of its huge expenditure in connection with the war was the main factor responsible for the expansion of currency and the consequent inflationary boom in prices. In the years immediately after the close of hostilities, government did not adopt a consistent budgetary policy to reverse the trend which had been set in motion during the war. As a result, budgetary deficits had continued till 1951-52. In that year there was a small surplus, but with the launching of a planned programme of economic development, budgetary deficits on a fairly large scale reappeared. However, the effect of the excess expenditure by the State in recent years on national economy as well as on the price structure has been different from that during the war period for the obvious reason that budget deficits in the last few years have been incurred in the cause of economic development, increased national investment and employment, while in the former period it was for purely destructive purposes.

At the close of the war it was hoped that with the end of the abnormal defence expenditure of about Rs. 600 crores annually, the inflationary trend in prices would be stopped and that it would give place to recession. In actual fact, however, as has been shown in Chapter III, the upward movement in prices continued. Between the close of the war and the first year of the Five Year Plan, the general index of wholesale prices moved up from 244.1 to 457.5. Simultaneously money supply increased from Rs. 2,179 crores in 1945-46 to Rs. 2,303 crores in 1947-48 at Partition; and over the five years, 1951-56, it varied between about Rs. 1,800 crores and Rs. 2,200 crores.

One of the major reasons for the failure of post-war budgetary policy to hold down rise in prices was that no conscious and consistent attempt was made by the government to use the means of tax



collection, public borrowing and public expenditure as an anti-inflationary agency. Apart from this, factors, to some extent outside the control of government, such as partition of the country and the political troubles arising from it, police action in Hyderabad and military action in Kashmir, labour troubles and fall in production in agriculture as well as in industry, not only prevented public expenditure from being brought down to the normal level but also helped in further rise in the prices of consumer goods. Lack of consistency in budgetary policy was directly due to the fact that at the close of the war forces of inflation as well as deflation seemed evenly matched, so that the Finance Ministers took upon themselves the responsibility of shaping the budgets in such manner as would not disturb the equilibrium. And in their attempts to steer clear of both inflation and deflation, they alternated between higher taxation and lower expenditure, with the result that no corrective step was taken to balance the budgets. In presenting the Budget for 1946-47, Sir Archibald Rowlands announced the objective of government's financial policy as one of avoiding the Scylla of increasing inflation and the Charbydis of too precipitate a deflation.<sup>1</sup> As a means of holding down inflationary trends, he stressed the importance of larger borrowing especially in rural areas and raised the rates of income-tax on incomes above Rs. 15,000 from 4 annas 9 pies to 5 annas in the rupee. On the other hand, to encourage greater investment and production, he abolished the Excess Profits Tax, encouraged Provincial Governments to spend more on development schemes and gave other concessions to industry in the form of lower import duty on raw materials and allowances such as the initial depreciation allowance of 10 per cent on new buildings and machinery and also on account of expenditure on research. His successor, Mr. Liaquat Ali Khan, pointed out that inflationary tendencies persisted even after the close of the war, but he attached greater importance in his budget to the attainment of certain social objectives, such as reducing the gross inequalities in wealth and income and easing the tax burden on the poor than to the arresting of the price trend. With the former objective in view, he raised the super tax and corporation tax and introduced the Business Profits Tax and the Capital Gains Tax. Abolition of salt duty and the raising of the minimum exemption limit in the case of income-tax from Rs. 2,000 to Rs. 2,500 were also in keeping with this policy.

<sup>1</sup> Finance Member's Budget Speech, 1946-47.



But the well meant social objectives of the Finance Minister failed to take note of the realities of the situation. In actual fact, the tax measures had an adverse effect on investment and production, while the social objectives remained as distant an ideal as ever before.

The policy of Mr. Liaquat Ali Khan was reversed by the next Finance Minister. Sir R. K. Shanmukham Chetty emphasized the need for controlling inflation as well as removing the various impediments to increased production. As an anti-inflationary measure budget surplus was to be attained. But this was to be achieved in such a way as to curtail spending and create suitable incentives for increasing production. In other words, tax measures should be such as would necessitate cutting down consumption expenditure and not affect savings. It was he who gave a definite turn to the tax policy by underlining the necessity for offering incentives for production. In his words, "While industry should be called upon to pay its just contribution to the common exchequer, the burden placed upon it must be such as to allow business to expand. At the same time, the aim of our policy should be to secure that, while the level of taxation is reasonably high so that the wealthier sections of the community are placed under an equitable contribution for the common needs of the State, a genuine margin is left for savings which would flow back into investment and thereby add to the productive wealth of the community, which the State itself could subsequently tap. It is also necessary so to adjust our taxation as to provide a real incentive to the ploughing back of profits into fresh business."<sup>1</sup> Tax concessions to business and industry took the form of a reduction in the rate of the Business Profits Tax from 16½ per cent to 10 per cent, increase in abatement from Rs. 1 lakh or 6 per cent of capital employed to Rs. 2 lakhs or 6 per cent, raising of the income limit assessable to super tax at the maximum rate to Rs. 3½ lakhs, reduction of the tax on the undistributed profits of companies by one anna in the rupee and reduction by 50 per cent of the income-tax on companies with incomes of Rs. 25,000 or less. Corporation Tax, however, was raised from 2 annas to 3 annas, but a rebate of one anna was to be allowed to companies declaring and distributing their dividends in India. At the same time, certain export duties were abolished and the import duty on machinery and raw materials was reduced. The fall in revenue arising out of these tax conces-

<sup>1</sup> Budget Speech, 1948-49.

sions was to be made good by increased indirect taxation, especially excise duties, which it was hoped would curtail consumption expenditure. The need for further reduction in government expenditure at the Central as well as the Provincial level was also emphasized as also the mopping up of surplus purchasing power through intensification of the Small Savings Campaign.

A significant change that came over the attitude of the Finance Ministers at this stage in the matter of the technique of fighting inflation is exemplified in their greater emphasis on increased production and reduced public expenditure. Increased investment and production were sought to be attained through the means of incentive taxation. Thus the Budget for 1949-50 aimed at checking inflation as well as at removing the fears of the business men caused by the stagnation in the capital market. To attain this end, various tax reliefs were granted, such as the abolition of the Capital Gains Tax, reduction of income-tax rates, liberal rebates in respect of Corporation Tax on public controlled small companies, withdrawal of the export duty on oilseeds and vegetable oils, rebate of half the duty on aviation spirit and relief in respect of customs duty on raw materials imported for industry, liberal depreciation allowances for newly installed plants and machinery and income-tax exemptions for certain new industrial undertakings. Once again, the loss in revenue on account of these tax concessions was planned to be covered by additional indirect taxes. These included enhancement in postal rates, increased surcharges on quasi-luxury goods, such as silk fabrics, art silk, woollens, earthenware and china, paper, stationery articles, glass and glassware, cutlery, metal furniture, flash lights, etc. raising of the import duty on motor spirit and on betel nuts, a new 15 per cent *ad valorem* duty on export of cigars, cigarettes and cheroots, increase in the excise duty on sugar, raising of the duty on tyres used for motor vehicles, and an excise duty on fine, medium and coarse cloth excluding handloom products. Furthermore, as part of the campaign against inflation, the whole programme of expenditure was reviewed with a view to reducing outlay and the Provinces were required to slow down temporarily their development expenditure.

The principle of incentive taxation and curtailment of expenditure was carried a step further in the next budget. It was now an accepted faith with the government that inflation could be successfully held down not by mopping up purchasing power through

taxation but by increasing production through tax incentives. In his Budget Speech, 1950-51 the Finance Minister remarked, "I am perfectly clear in my own mind that the effect of the present level of taxation is not disinflationary but positively inflationary, because if you take the line that the solution to the problem of inflation is production, then a very high level of taxation which reduces the margin of saving and the amount available for investment is a potential inflationary force." In conformity with this dogma, further tax concessions were granted to business in the shape of abolition of Business Profits Tax and further reduction in income-tax rates. At the same time development expenditure was reduced. Grants and advances to States for development were drastically curtailed and the deficit in the capital budget was brought down considerably.

From what has been outlined above, three things emerge clear. In the first place, there was a lack of consistency, at least in the earlier years of this period, in the matter of budgetary policy as a means of inflation control. This has to be explained partly by the unpredictable trends in the economic sphere, partly by the political happenings of the times and to some extent by the personal bias of persons in charge of the State finance. Secondly, subsequent to 1948-49 greater and greater emphasis came to be attached to incentive taxation as a means of controlling inflation *via* increased investment and production. Such a method, it may be observed, cannot by its very nature yield any immediate results and its success as a long term measure depends on various other factors, such as the fiscal policy of the government, foreign trade, nature of the home market and general economic conditions. Lastly, curtailment of development expenditure, which became a notable feature in the last two years of the period under review, does not fit in with the principle on which incentive taxation is based. The inflationary effect of development expenditure will be reviewed in the next section.

While no settled policy was possible in the presence of conflicting fears about inflation and deflation in the immediate post-war period, budget deficits continued. Although defence expenditure came down sharply, political troubles arising in the wake of Partition necessitated an outlay on defence and internal security larger than what normal conditions would require. The size of budgetary deficits in the five years after the return of peace is shown in Table 30.

TABLE 30

## OVERALL BUDGETARY POSITION OF THE GOVERNMENT OF INDIA, 1946-47 TO 1950-51

(In crores of rupees)

| Year     | Revenue<br>account<br>surplus (+)<br>deficit (—) | Capital<br>account<br>surplus (+)<br>deficit (—) | Miscella-<br>neous (net)*<br>surplus (+)<br>deficit (—) | Overall<br>surplus (+)<br>deficit (—) |
|----------|--|--|---|---------------------------------------|
| 1946-47  | — 0.60   | — 56.99  | —   | — 57.59                               |
| 1947-48† | — 6.52   | —133.41  | + 29.25   | —110.68                               |
| 1948-49  | + 50.84  | —167.48  | + 34.97   | — 81.67                               |
| 1949-50  | + 33.27  | — 80.05  | + 2.98  | — 43.80                               |
| 1950-51  | + 59.22  | — 52.04  | + 15.26   | + 12.44                               |

\* Including miscellaneous deposits and advances, remittances and others.

† From 15th August 1947 to 31st March 1948.

(Source: *Reports on currency and Finance*, Reserve Bank of India.)

Recoverable war expenditure dwindled to Rs. 51.62 crores in 1946-47 from Rs. 374.54 crores in the previous year. While total expenditure on defence, including recoverable war expenditure and defence expenditure on India's account, stood at Rs. 734.77 crores in 1945-46, it came down to Rs. 146 crores in 1948-49. It should however be remembered that the fall would have been much more significant but for the political disturbances in the country. On the other hand, civil expenditure increased from Rs. 124.38 crores in 1945-46 to Rs. 168.26 crores in 1949-50 and to Rs. 187.31 crores in 1950-51. But alongside of this increase in expenditure there was a corresponding expansion on the revenue side also, so that the budgets of the five years, 1946-47 to 1950-51, showed on the revenue side a net surplus of Rs. 136.21 crores. As against this, the capital account of the budget during this period consistently showed a deficit, which aggregated over the five-year period to Rs. 499.97 crores. Deducting the net aggregate surplus on revenue account of Rs. 136.21 crores and making an adjustment for miscellaneous deposits and advances, the net deficit comes to Rs. 306.18 crores. Apart from this deficit in the Central Government's budgets, an important fact to be remembered is that, while in the war years Provincial budgets invariably closed with surpluses, in the post-war period the outlay of the Provinces tended to exceed receipts. This was the outcome of the new development plans which they began to put into operation.



This deficit in the Central Government's budget would not have aggravated inflationary pressure if it had been covered by borrowing. In actual fact, this method, which had been successfully used in the war period to cover a substantial portion of the total budgetary deficit, failed in the post-war years. In a large measure this was due to the political disturbances in the country and the feeling of insecurity among the people. To some extent it was also due to the fact that with the end of fighting and the relaxation of controls there was a natural tendency to spend more rather than save. Throughout these years the actual collections by way of loans fell far short of the estimates. (See Table 31.)

TABLE 31  
COLLECTIONS THROUGH NEW LOANS  
(In crores of rupees)

| <i>Year</i> | <i>Budget</i> | <i>Actuals</i> |
|-------------|---------------|----------------|
| 1946-47     | 250           | 112            |
| 1947-48     | 150           | 41             |
| 1948-49     | 150           | 55             |
| 1949-50     | 85            | 40             |
| 1950-51     | 85            | 38             |

Small savings did not show any improvement and the total interest-bearing obligations of the government in India showed only a slight increase from Rs. 2,413 crores in 1948-49 to Rs. 2,500 crores in 1950-51.

Since government could not collect the necessary funds by means of borrowing to cover the budget deficit, recourse was had to the utilization of government's cash balances. The progressive decline in the cash balances is seen in Table 32.

TABLE 32  
GOVERNMENT'S CASH BALANCES, 1946-51  
(In crores of rupees)

| <i>Year</i> | <i>Opening balance</i> | <i>Closing balance</i> |
|-------------|------------------------|------------------------|
| 1946-47     | 529.53                 | 417.95                 |
| 1948-49     | 273.90                 | 192.23                 |
| 1949-50     | 193.28                 | 149.48                 |
| 1950-51     | 149.50                 | 161.94                 |



In so far as running down of the government's cash balances represents utilization of former and not current savings, this method of financing the deficit resulted only in the activation of idle funds and in the increase of purchasing power with the public. Between 1948-49 and 1950-51, notes in circulation increased by about 75 crores of rupees and in 1950-51 total money supply with the public registered a rise of about Rs. 100 crores over the previous year. The net result therefore must be considered as further aggravation of the inflationary trend.

### *Development Finance and Inflation*

The most important factor in recent years affecting the budgetary policy of the State and through it the price structure in the country is the large annual outlay incurred by the Central and State Governments on schemes of development. Reconstruction and development programmes started soon after Partition and Provincial Governments began to vie with one another in laying out ambitious development projects. In addition to advances from the Union Government, the States began to utilize the reserves which they had built up during the war and resorted to borrowing from the public. However, it was only with the finalizing of the First Five Year Plan and the commencing of its execution in 1951-52 that the States and the Central Governments entered upon an era of economic development planned on a comprehensive national scale. The extent to which annual development outlay envisaged in the Five Year Plan could affect the economy and budgetary policy of the country can be known from the fact that in the five years, 1951-52 to 1955-56, of the total expenditure incurred by the Union Government and by the Part A and B States, over 30 per cent was accounted for by development projects under the Plan. The total expenditure incurred by the Central and State Governments on development schemes in 1955-56 of about Rs. 700 crores was roughly three times the entire expenditure incurred by the Central Government and the provinces in 1938-39. Between 1951-52 and 1955-56, while the expenditure of the Government of India on revenue account increased by 26 per cent, total development expenditure on capital account increased nearly three fold. The releasing of such a large volume of purchasing power annually is bound to have very significant repercussions on the national economy.

The First Five Year Plan period ended with March 1956. During this period the Central and State Governments spent about Rs. 2,000 crores as detailed in Table 33.

TABLE 33  
OUTLAY ON THE FIRST FIVE YEAR PLAN, 1951-56  
(In crores of rupees)

|              | <i>Accounts</i> |         |         |         | <i>1955-56<br/>revised<br/>estimate</i> | <i>Total<br/>for<br/>1951-56</i> |
|--------------|-----------------|---------|---------|---------|---|----------------------------------|
|              | 1951-52         | 1952-53 | 1953-54 | 1954-55 |   |                                  |
| Centre       | 132.1           | 125.4   | 181.3   | 283.6   | 392.5                                   | 1114.9                           |
| States       | 127.3           | 142.2   | 161.7   | 192.3   | 274.0                                   | 897.5                            |
| <i>Total</i> | 259.4           | 267.6   | 343.0   | 475.9   | 666.5                                   | 2012.4                           |

(Source: *Review of the First Five Year plan*, Government of India.)

As originally laid down, the Plan envisaged a total outlay by the Centre and the States of Rs. 2,069 crores. Later adjustments raised the size of the Plan to Rs. 2,378 crores of which the expenditure to be incurred by the Centre was Rs. 1,390 crores and that by the States Rs. 968 crores. Since the actual expenditure in the last year of the Plan was only Rs. 625 crores (against the revised estimate figure of Rs. 666.5 crores), the total outlay over the five years amounts to Rs. 1,971 crores. This represents a short-fall of Rs. 407 crores or 17 per cent against the revised outlay target. It should be noted that although the Plan had only a slow start in the first two or three years, there was a substantial step up in the last two years during which as much as 57 per cent of the aggregate outlay was incurred. The figures in Table 34 indicate the various sources of finance and their relative significance during the First Five Year Plan period.

Of the total outlay of about Rs. 2,000 crores incurred by the Centre and States, investment expenditure in the public sector accounts for Rs. 1,500 crores. Apart from this, investment in the private sector in this period has been estimated at Rs. 1,600 crores so that over the five years 1951-52 to 1955-56 aggregate investment in the economy would have amounted to Rs. 3,100 crores.

TABLE 34

FINANCING OF THE FIRST FIVE YEAR PLAN, 1951-52 TO  
1955-56, CENTRE AND STATES

(In crores of rupees)

|  | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56* | 1951-56 |
|--|---------|---------|---------|---------|----------|---------|
|  | (1)     | (2)     | (3)     | (4)     | (5)      | (6)     |
| Budgetary Resources:                                 | 204.8   | 141.3   | 246.1   | 368.6   | 316.5    | 1277.3  |
| 1. Savings of public authorities                     |         |         |         |         |          |         |
| (a) From current revenues:                           | 183.0   | 98.8    | 86.7    | 123.7   | 82.1     | 574.3   |
| (b) From railways:                                   | 37.7    | 23.5    | 12.8    | 19.5    | 21.9     | 115.4   |
| 2. Private savings absorbed through                  |         |         |         |         |          |         |
| (a) Loans from the public:                           | -22.8   | 15.7    | 2.4     | 119.7   | 89.4     | 204.4   |
| (b) Small savings and unfunded debt:                 | 48.6    | 48.7    | 53.0    | 70.5    | 82.8     | 303.6   |
| (c) Deposits, funds and other miscellaneous sources: | -41.7   | -45.4   | 91.2    | 35.2    | 40.3     | 79.6    |
| 3. Gap in resources:                                 | 54.6    | 126.3   | 96.9    | 107.3   | 350.0    | 735.1   |
| 4. External assistance grants and loans:             | 64.9    | 45.6    | 18.5    | 16.0    | 58.2     | 203.2   |
| 5. Deficit:  | -10.3   | 80.7    | 78.4    | 91.3    | 291.8    | 531.9   |

\* Revised estimate

(Source: *Review of the First Five Year Plan*, Government of India.)

The extent to which investments by the Union and State Governments constituted an excess demand on the resources available in the economy is broadly indicated by the relative significance of the different sources of finance. As originally formulated, domestic resources to be raised by way of taxes, loans, small savings, etc. were estimated at Rs. 1,258 crores and the balance of Rs. 811 crores was proposed to be covered by additional taxation and deficit

financing. It was hoped that the scope of the last mentioned method of financing would be restricted to about Rs. 290 crores which corresponded to the drawal of sterling balances. Actually budgetary resources exceeded the target figures slightly but the utilization of external finance came to about Rs. 200 crores only with the result that deficit financing had to exceed the limit of Rs. 290 crores.

Expenditure of the Central Government in the five years amounted to Rs. 1,115 crores. Against this, resources available to the Centre in the shape of current revenues, contribution from railways and collection of private savings through loans, small savings, deposits, funds, etc. amounted to Rs. 778 crores. Out of this total, the Centre transferred Rs. 350 crores to the States by way of Central assistance for State Plans. Deducting this, the financial resources available for the Union Government amounted to Rs. 428 crores. Since an amount of Rs. 203 crores became available in the form of external assistance the net deficit in the five years budget of the Centre aggregated to Rs. 484 crores. The States in their turn spent Rs. 898 crores. Their budgetary resources for plan expenditure including balance from revenue account, loans from public and deposits and other miscellaneous receipts amounted to Rs. 500 crores. Adding the Central assistance of Rs. 350 crores, the deficit in the resources of the State Governments works out to Rs. 48 crores. Thus the overall deficit in the Central and State budgets on account of outlays on the First Five Year Plan amounted to Rs. 532 crores or 26 per cent of the aggregate outlay of Rs. 2,012 crores. This was much more than what was anticipated by the planning authorities. It was necessitated partly by lack of resilience on the part of budgetary resources and partly by an overestimate of the availability of foreign resources and of the capacity of the economy to absorb such resources. External assistance in the form of loans and grants available for the public sector in the five years aggregated to Rs. 296 crores of which only about Rs. 200 crores was utilized in the First Plan period leaving a carry forward of about Rs. 100 crores for the next plan period.

Although the budgetary resources of the Centre and the States amounted to Rs. 1,277 crores against the estimated receipts of Rs. 1,257 crores, it is worth recalling the fact that the Plan envisaged a gap between resources and outlay of Rs. 811 crores but hoped that nearly half of this would be covered by additional taxation, further external assistance and larger deficit financing (i.e. in addi-



tion to Rs. 290 crores laid down as a tentative upper limit). It is clear that with a greater measure of tax effort the collections from tax revenues could have been made larger and the resort to the inflationary method of deficit financing would have been much restricted. A review of the budgetary resources of the Centre and the States in the five years of the First Plan period shows that budgetary resources fluctuated considerably from year to year declining from Rs. 205 crores in 1951-52 to Rs. 141 crores in the next year and from Rs. 369 crores in 1954-55 to Rs. 317 crores in 1955-56.

TABLE 35  
BUDGETARY RESOURCES FOR FINANCING THE  
FIRST FIVE YEAR PLAN  
(In crores of rupees)

|                                 | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | Total<br>1951-56 |
|---------------------------------|---------|---------|---------|---------|---------|------------------|
| Current revenues                | 183.0   | 98.8    | 86.7    | 123.7   | 82.1    | 574.3            |
| From railways                   | 37.7    | 23.5    | 12.8    | 19.5    | 21.9    | 115.4            |
| Loans from the public           | -22.8   | 15.7    | 2.4     | 119.7   | 89.4    | 204.4            |
| Small savings and unfunded debt | 48.6    | 48.7    | 53.0    | 70.5    | 82.8    | 303.6            |
| Deposits, funds, etc.           | -41.7   | -45.4   | 91.2    | 35.2    | 40.3    | 79.6             |
| Total                           | 204.8   | 141.3   | 246.1   | 368.6   | 316.5   | 1277.3           |

(Source: *Review of the First Five Year Plan*, Government of India.)

Savings from revenues were exceptionally large in the first year of the Plan due mainly to the buoyancy of revenues associated with the Korean boom. In the next two years disinflationary trends caused a fall in revenues. It has been estimated that over the First Plan period while national income increased by about 18 per cent total consumption also went up by about 16 per cent and the proportion of savings through taxation remained more or less constant at about 7 per cent. In the matter of public savings as between the Centre and the States, the latter fared badly. While the Centre was able to collect from current revenues Rs. 145 crores more than the

plan targets required, the contribution from revenues to the States' finances amounted to Rs. 269 crores as compared with the Plan estimate of Rs. 410 crores, i.e. a short-fall of about 34 per cent. This occurred in spite of a transfer of about Rs. 80 crores from the Centre to the States, as per the Finance Commission's Award. The short-fall in savings from current revenues in States was due partly to the failure to realize the targets of revenues from additional taxation and partly to the increases in developmental expenditure outside the Plan. As against the assumption in the Plan that over the five years the States would have raised about Rs. 230 crores from additional measures of taxation, they were able to realize only Rs. 80 crores. The increase in receipts from taxes on motor vehicles and sales tax on motor spirit and other taxes and duties was offset by a decline under State excise and inter-state transit duties. For the Centre and the States as a whole tax revenue shows only a slight improvement over the five years. The total tax receipts, Centre and States, formed 6.6 per cent of national income in 1950-51 increased to 7.5 per cent in the next year, but declined in the year 1953-54 to 6.4 per cent and again rose to 7.9 per cent in the last year of the First Plan. On the average it remained at about 7 per cent of national income in the Plan period.

As against public savings, receipts from private savings were quite encouraging. Over the five years, market loans of the Centre and the States brought in Rs. 204.4 crores against the target of Rs. 115 crores. In the first three years of the Plan the Union Government made net repayments of public loans amounting to Rs. 72.3 crores but in the next two years collected Rs. 121.3 crores. The net collections by this means in the Plan period thus amounted to Rs. 49 crores. The States' collections through public loans steadily increased from the first year of the Plan and aggregated to Rs. 155.4 crores over the five years. Besides, receipts from small savings and unfunded debt of the Centre and States, over the Five Year Plan period, amounted to Rs. 303.6 crores representing an excess of Rs. 33.6 crores over the Plan target of Rs. 270 crores. The collections from small savings at the end of the Plan were about double the collections in the first year and these financed about 12 per cent of the total Plan outlay.

Thus savings of public authorities through current revenues and the Railways plus savings absorbed through loans from the public, small savings, etc. aggregated to Rs. 1,277.3 crores, leaving a gap

in resources of Rs. 735.1 crores against the total outlay. External assistance utilized in the five years amounted to Rs. 203.2 crores. Thus, the net deficit was Rs. 531.9 crores. It is this part of the financing of the Plan outlay that is significant in the matter of the inflationary potential of the developmental expenditure.

In order to help in an assessment of the expansionary effect of the gap between total outlay and resources on money supply with the public, budgetary deficit of the Central Government has been equated with the aggregate of the increase in its floating debt held by the Reserve Bank and the decrease in the cash balances of the Central Government with the Reserve Bank. In a like manner, advances of the Reserve Bank to the State Governments and the decline in their cash balances represent the size of deficit financing of the States. Of the total deficit of Rs. 531.9 crores, the Central Government accounted for Rs. 483.8 crores and deficit financing of the States was of the order of Rs. 48.1 crores. Over the first three years the deficit of the Central budget was covered mostly by drawing on its cash balances and in the last 2 years of the Plan mainly by borrowing from the Reserve Bank. At the end of the Plan period increase in floating debt of the Central Government amounted to Rs. 346.9 crores, sale of securities Rs. 25.2 crores and withdrawal from cash balances Rs. 111.7 crores, the three items totalling Rs. 483.8 crores. As for the States' deficit of Rs. 48.1 crores, it was met to the extent of Rs. 21.1 crores by increase in floating debt, and Rs. 10.2 crores by sale of securities, while withdrawal from cash balances amounted to Rs. 16.8 crores. It is worth examining how far deficit financing of this magnitude by the means mentioned above reacted on money supply and prices in the country.

Over the five years 1951-56 the rise in money supply was Rs. 264 crores or 14 per cent. In 1950-51, the year preceding the launching of the Five Year Plan, there was a considerable decline in government deficit as a result of increase in revenues. But speculative stock building necessitated a large expansion of credit and an increase in the currency with the public. The budget of the Central Government showed a small surplus in 1951-52, but in the next year 1952-53, expenditure on revenue and capital account exceeded receipts. Despite this budgetary deficit and the fact that there was no large-scale balance of payments deficit, money supply contracted by about Rs. 39 crores. This was due to several factors, such as the

large part played by foreign financing,<sup>1</sup> large absorption of public debt by private savers and contraction of commercial credit. Thus, while the total deposits and currency with the public remained constant, there was a sharp decline in scheduled bank credit. Furthermore, large investments by the government did not produce any inflationary effect because of a decline in private investment which itself was due in some measure to the tighter credit policy of the Reserve Bank and severe controls on private investment and to a large extent to the lack of confidence among the business community in the earning prospects of industry. The combined effect of budgetary deficit and balance of payments surplus is seen in 1953-54 in an increase in money supply. The appreciable stepping up of the rate of expenditure in the last two years of the Plan and deficit financing on a large scale through the creation of Treasury Bills resulted in a considerable expansion in the volume of money supply. While in the first three years of the Plan there was a net decline of Rs. 185 crores in money supply, in the last two years there was an increase of the order of Rs. 390 crores. These monetary developments did not, however, cause any strain on the nation's economy at least until towards the close of the Plan. It may be said that to a large extent deficit financing of this magnitude served only to neutralize the post-Korean deflationary forces. On the other hand, the considerable increase in agricultural output in 1953-54 and 1954-55 produced a depression in agricultural prices. While money supply in 1954-55 increased by nearly 7 per cent, the level of wholesale prices actually fell by some 5 per cent. This would indicate that at least until the close of the fourth year of the First Plan period, despite deficit financing, monetary expansion was in accordance with the requirements of a growing economy.

With even larger spendings in the last year of the Plan and larger budgetary deficits, money supply went up by more than Rs. 260 crores. Simultaneously, since the middle of 1955, prices, especially of agricultural commodities, have shown an uptrend. While this adverse effect on the economy, in the form of a rise in price level, has to be attributed partly to a decline in agricultural production, it is in the main an indication of the fact that the economy was by this time rapidly reaching the limits of its capacity to absorb deficit financing.

<sup>1</sup> The rupee proceeds from foreign loans and grants and drawing from International Bank loans yielded the government about Rs. 44 crores. U.N., *Economic Survey of Asia and the Far East*, 1953, p. 68.



## CHAPTER VII

### DEVELOPMENT FINANCE AND INFLATION (Contd.)

FROM THE point of view of its effects on inflation the Second Five Year Plan appears to have started under unfavourable circumstances. The close of the First Plan witnessed a substantial rise in the rate of development spending by the government. In the last two years of the Plan, the rate of development expenditures was about double that in the first two years. The bulk of the deficit financing of the First Plan period also occurred in these years. Money supply with the public went up by Rs. 127 crores in 1954-55 and by another Rs. 264 crores in 1955-56. In the last year of the Plan, scheduled bank credit recorded an increase of 22 per cent. On the other hand, food production receded from the high level reached in 1953-54; and the index of National Income at constant prices increased by less than 4 per cent between 1953-54 and 1955-56. Consequently price level in the country spurted up and it was found even at the very early stages of the Second Plan that the cost estimates of some of the projects had to be raised. The emphasis on major industrial investment projects and the proposal to resort to deficit financing on a large scale created a psychological climate favourable to a further acceleration of investment in the economy. Against this mounting costs and prices, resources available in the economy were seen to be inadequate. The growing imbalance between the resources available and the demands on them was reflected in the adverse trend in the balance of payments position of the country. On top of these came the Suez crisis which considerably aggravated this adverse trend.

The inflationary impact of any scheme of planned economic development depends on the method of its financing and the pattern of outlay which it embodies. If the state plays a predominant part in planned development, it has to mobilize the necessary resources through taxation and borrowing. The collection of revenues through taxation and the receipts of the State through internal borrowing and small savings constitute the monetary counterpart of the real resources which the community is made to part with either compulsorily or voluntarily. If the resources realizable in this manner are inadequate the State can resort to deficit financing by means of which it attempts to attract resources away from direct consumption

or from lines of investment which are of a second order of importance. The rise in prices resulting from this excess demand helps in the transfer of resources by restricting consumption and increasing forced savings. Viewed in this manner deficit financing broadly reflects the magnitude of excess demand and constitutes a source of inflation.

In addition to the method of financing, the pattern of expenditure in a plan also reacts on prices. The major part of the Plan outlay is for investment purposes. But investment may be quick or slow yielding. Outlays on minor irrigation schemes or on the development of small or cottage industries result quickly in increased production, while large investment schemes like hydroelectric projects, steel plants or communications which are necessary for providing the social overheads essential for economic growth, are of the slow yielding type. Such investments provide large-scale employment and release a large volume of purchasing power in the community but do not, in the initial stages at least, help in increased output to match the demand they create. The inflationary potentiality of such investments is thus obvious. It may, therefore, be generalized that in any assessment of the inflationary effects of planned economic development these two important aspects, method of financing and pattern of investment expenditure are to be taken into account.

It is against this background that the broad features of the Second Five Year Plan are to be reviewed. As originally laid down, the Plan envisaged a total expenditure of Rs. 4,800 crores over the years 1956-57 to 1960-61. Of this Rs. 3,800 crores represented investment expenditure and Rs. 1,000 crores current developmental expenditure. The distribution of the investment expenditure under the major heads according to the Plan is given in Table 36.

Of these heads of expenditure, large and medium industries and mining, transport and communications and electric power projects are of the slow yielding type, necessary for the construction of a strong base for the economy to grow. Irrigation and flood control also to some extent partake of this nature. If half of the expenditure under this last head is assumed to be of the major investment type, the total outlay of this group would be Rs. 2,640 crores or 70 per cent of the entire investment outlay. On the other hand investment in which the lag between capital formation and the generation of additional income is much shorter like agriculture, national extension and community development, social services

TABLE 36

## DISTRIBUTION OF INVESTMENT EXPENDITURE AMONG THE MAJOR HEADS IN THE SECOND FIVE YEAR PLAN

(In crores of rupees)

|   |     |      |
|---|-----|------|
| 1. Agriculture and community development          |     | 388  |
| (i) Agriculture                                   | 181 |      |
| (ii) National extension and community development | 157 |      |
| 2. Irrigation and power                           |     | 863  |
| (i) Irrigation and flood control                  | 456 |      |
| (ii) Power  | 407 |      |
| 3. Industries and mining                          |     | 790  |
| (i) Large and medium industries and mining        | 670 |      |
| (ii) Village and small scale industries           | 120 |      |
| 4. Transport and communication                    |     | 1335 |
| 5. Social services                                |     | 455  |
| 6. Miscellaneous                                  |     | 19   |
| <i>Total</i>                                      |     | 3800 |

and miscellaneous and part of the outlay on irrigation and flood control account for Rs. 1,160 crores or 30 per cent. It is worth observing that the items in the first category absorbed 44 per cent of the total plan expenditure in the First Five Year Plan while the expenditure on the items in the second category totalled Rs. 1,133 crores or 56 per cent. Among the individual items in the first group agriculture took up 10.2 per cent and industries and mining 7.6 per cent of the aggregate while in the Second Plan, agriculture accounted for 7.1 per cent and industries and mining 18.5 per cent of the total plan expenditure.

It was envisaged that by means of a total developmental outlay over the five years of Rs. 4,800 crores the national income could be increased by 25 per cent or at an annual rate of 5 per cent and the rate of investment could be stepped up from about 7 per cent of the national income to 11 per cent. Resources to finance this outlay were expected to be found to the extent of Rs. 800 crores from taxation, Rs. 1,200 crores from public borrowing, Rs. 400 crores from Railways, Provident Fund and other deposits and from external sources Rs. 800 crores. The gap of Rs. 1,600 crores was expected to

be covered by additional measures to raise domestic resources, Rs. 400 crores, and deficit financing, Rs. 1,200 crores (Table 37). The estimated yield of tax resources namely, Rs. 800 crores exceeds the target in the First Plan by Rs. 200 crores and the actual receipts by more than Rs. 300 crores. It should further be noted that even if the receipts from taxation, borrowing, external finance and other budgetary sources were realized to the full, and deficit financing was resorted to to the extent of Rs. 1,200 crores, there would still be a gap of Rs. 400 crores, for the covering of which the only source available was taxation and profits of public enterprises.<sup>1</sup> This would mean that if the receipts from the other sources did not fall below the estimates and deficit financing was within the limits indicated, then taxation should yield at least Rs. 1,200 crores. If it did not increase so much and if the actual outlay on the Plan were not to fall short of the estimates, deficit financing would have further to be increased to that extent.

TABLE 37  
FINANCING OF THE SECOND FIVE YEAR PLAN  
(AS ORIGINALLY PROPOSED)  
(In crores of rupees)

|   |     |      |
|---|-----|------|
| 1. Surplus from current revenues  |     | 800  |
| (a) at existing (1955-56) rates of taxation                             | 350 |      |
| (b) additional taxation   | 450 |      |
| 2. Borrowings from the public   |     | 1200 |
| (a) Market loans  | 700 |      |
| (b) Small savings   | 500 |      |
| 3. Other budgetary sources  |     | 400  |
| (a) Railways contribution   | 150 |      |
| (b) Provident funds and other deposits                                  | 250 |      |
| 4. Resources to be raised externally                                    |     | 800  |
| 5. Deficit financing  |     | 1200 |
| 6. Gap to be covered by additional measures to raise domestic resources |     | 400  |
| <i>Total</i>  |     | 4800 |

*Appraisal of the Plan Outlay, May 1958*

The mounting strain on the external and internal resources available during the first two years of the Plan necessitated an appraisal

<sup>1</sup> Government of India, Planning Commission, *Second Five Year Plan*, p. 78.



of the position in May 1958. It was then realized that the resources over the five year period would not exceed Rs. 4,260 crores representing a short-fall from the original estimate to the tune of Rs. 540 crores or 11 per cent. Since due to rise in prices the original cost estimates of some of the projects had to be adjusted upward it was found necessary to bring about a reduction in the physical targets. However, the National Development Council at this stage proposed to keep the overall outlay target at Rs. 4,800 crores, but required that this total outlay should be divided into two parts between (a) projects of primary importance which had advanced fairly well and the completion of which was necessary to fulfil the targets of production, and (b) other projects which were not of such great importance. The first or "core" projects were estimated to absorb Rs. 4,500 crores and the rest of the projects Rs. 300 crores. The expenditure on the latter was to be undertaken only to the extent additional resources became available. Besides, even among the "core" projects some readjustments in outlay were made. According to this revision, the outlay on agriculture and community development and village and small industries as originally envisaged was left unchanged, but the expenditure on irrigation and power was lowered from the original of Rs. 913 crores to Rs. 860 crores; and that on transport and communications, social services and miscellaneous was brought down from Rs. 1,385 crores to Rs. 1,345 crores, from Rs. 945 crores to Rs. 863 crores and from Rs. 99 crores to Rs. 84 crores respectively. On the other hand, the outlay on Industry and Mining was raised from Rs. 690 to Rs. 880 crores. Thus while the total was left unaltered, the proportion on Industry and Mining was increased from 14.4 per cent to 18.4 per cent of the aggregate outlay, this rise being offset by slight downward adjustments in the other heads.

#### *Progress of the Second Plan*

The total outlay on the Second Plan incurred by the Centre and the States in the first three years 1956-57 to 1958-59 amounted to about Rs. 2,500 crores. This works out to 52 per cent of the original provision of Rs. 4,800 crores leaving 48 per cent of the expenditure to be incurred in the last two years. The distribution of this expenditure among the major heads of development and its progress over the three years are shown in Table 38.

TABLE 38

**PROGRESS OF EXPENDITURE UNDER THE SECOND  
FIVE YEAR PLAN IN THE FIRST THREE YEARS**

(In crores of rupees)

| <i>Heads of outlay</i>                           | 1956-57       | 1957-58       | 1958-59        | <i>Total for<br/>3 years<br/>1956-59</i> | <i>Balance<br/>to reach<br/>target of<br/>outlay</i> |
|--|---------------|---------------|----------------|--|--|
| 1. Agriculture and<br>community deve-<br>lopment | 69.0<br>(12)  | 85.8<br>(15)  | 109.2<br>(18)  | 264.0<br>(46)                            | 304.0<br>(54)  |
| 2. Irrigation and po-<br>wer                     | 162.5<br>(18) | 161.0<br>(18) | 164.7<br>(18)  | 488.2<br>(54)                            | 424.8<br>(46)  |
| 3. Industry and min-<br>ing                      | 81.5<br>(9)   | 227.3<br>(26) | 279.3<br>(31)  | 588.1<br>(66)                            | 301.9<br>(34)  |
| 4. Transport and<br>communications               | 217.5<br>(16) | 286.7<br>(21) | 283.9<br>(20)  | 778.1<br>(57)                            | 606.9<br>(43)  |
| 5. Social services                               | 88.0<br>(9)   | 106.7<br>(11) | 143.6<br>(15)  | 338.3<br>(35)                            | 606.7<br>(65)  |
| 6. Miscellaneous                                 | 14.9<br>(15)  | 16.7<br>(17)  | 20.7<br>(21)   | 52.3<br>(53)                             | 46.7<br>(4)  |
| <b>Total</b>                                     | 633.4<br>(13) | 884.2<br>(18) | 1001.4<br>(21) | 2519.0<br>(52)                           | 2281.0<br>(48)                                       |

Note: Figures within brackets indicate percentages to the corresponding Second Plan provision.

(Source: *Second Five Year Plan, Progress Report 1958-59*, Planning Commission, Government of India.)

It may be noted that among the different heads of expenditure considerable progress has been made in respect of Industry and

Mining. The total outlay on this head in the three years amounting to Rs. 588 crores is 72 per cent of the provision of the original plan and 66 per cent of the provision as revised in 1958. Outlay on Transport and Communications and on Irrigation and Power has also been large, but there has been a considerable lag under Agriculture and Community Development and Social Services—precisely those lines of investment which yield quicker returns, and the completion of which helps in enlisting the co-operation of the people in so far as the benefits of such investments are easily perceivable by the average tax-payer in the village.

On the resources side, the most significant feature in the financing of the Plan in the first three years is the wide gap between the estimates and actuals of the domestic resources (Table 39). Against the anticipated receipts of Rs. 1,200 crores from current revenues over the five years, the actual amount available in the first three years totalled only Rs. 427.5 crores or less than 36 per cent. And this in spite of strenuous efforts on the part of both the Central and State Governments to collect the maximum amount possible from additional taxation. Since the beginning of the Second Plan the tax policy of the State has aimed at reorientating the tax structure to the needs of development planning. Along the lines suggested by the Taxation Enquiry Commission a number of tax changes have been introduced. In spite of much widening and deepening of the tax base the Central Government's receipts from additional taxation have fallen much short of the anticipations. In the States, additional measures of taxation yielded Rs. 11.6 crores in 1956-57, Rs. 30.6 crores in 1957-58 and Rs. 50.6 crores in the next year. The yield from public loans at the Centre and the States and from small savings has also not been quite satisfactory. Against an anticipated Rs. 1,200 crores from this source the actual collections amounted at the end of the third year to only Rs. 673 crores. That these borrowings have considerably strained the market is indicated by the fact that in 1958-59 the securities of a number of State Governments were quoted at a sizeable discount. Also the Reserve Bank of India had to give a good deal of support to the capital market and some of the State Governments had to repurchase their own securities. Of late, there has been some improvement under these heads, particularly in respect of small savings, but the recent Central Government floatations have not received adequate response from the public.

TABLE 39

SECOND PLAN OUTLAY AND FINANCING IN THE  
FIRST THREE YEARS\*

(In crores of rupees)

| Items  | 1956-57 | 1957-58 | 1958-59 | Total<br>for three<br>years<br>1956-59 | Plan<br>esti-<br>mates<br>(origi-<br>nal) | 6-5    |
|--|---------|---------|---------|--|---|--------|
| 1  | 2       | 3       | 4       | 5                                      | 6   | 7      |
| 1. Plan outlay   | 638.8   | 845.9   | 981.4   | 2466.1                                 | 4800                                      | 2333.9 |
| 2. Domestic resources                                      |         |         |         |  |   |        |
| (a) Balance from cur-<br>rent revenues                     | 145.4   | 155.7   | 126.4   | 427.5                                  | 1200                                      | 772.5  |
| (b) Contribution of<br>railways                            | 34.1    | 40.0    | 52.0    | 126.1                                  | 150                                       | 23.9   |
| (c) Loans from the<br>public                               | 145.9   | 78.1    | 238.1   | 462.1                                  | 700                                       | 237.9  |
| (d) Small savings  | 58.7    | 69.6    | 82.6    | 210.9                                  | 500                                       | 289.1  |
| (e) Unfunded debt<br>and miscellaneous<br>capital receipts | -22.2   | -87.3   | 9.4     | -100.1                                 | 250                                       | 350.1  |
| Total of (a) to (e)  | 361.9   | 256.1   | 508.5   | 1126.5                                 | 2800                                      | 1673.5 |
| 3. External assistance                                     | 37.8    | 95.0    | 325.0   | 457.8                                  | 800                                       | 342.2  |
| 4. Total resources 1 to 3                                  | 399.7   | 351.1   | 833.5   | 1584.3                                 | 3600                                      | 2015.7 |
| 5. Budgetary deficit 1-4                                   | 239.1   | 494.8   | 147.9   | 881.8                                  | 1200                                      | 318.2  |

\* This statement does not incorporate the actuals for 1958-59 contained in the Budget for 1960-61. Hence difference in the totals given in this Table and Table 38.

(Source: *Second Five Year Plan, Progress Report 1958-59*, Planning Commission, Government of India.)

That the Plan has gone awry in the matter of its assessment of domestic resources is thus clear. It appears that the estimates of the yield from taxes, internal borrowings and small savings were over optimistic. Obviously, it is wrong to take it for granted that economic development—whether it is planned or otherwise—would automatically increase the domestic resources at the disposal of the government. The basic point to remember here is that the source of collection by way of taxation and borrowing is the margin



of difference between what the community produces and what it consumes. Assuming that income is increased, it does not necessarily follow that this margin is widened. Economic development implies the creation of incomes, but it can at the same time distort the distribution pattern in such manner as to reduce the margin of savings. Much has been said about what is called the marginal rate of taxation, the need to increase it and keep down the marginal propensity to consume of the people. The idea behind this suggestion is that since development increases income, a larger and larger fraction of this increment is to be appropriated for investment purposes, if the rate of growth of the economy is to be accelerated. It is calculated that income would increase over the five years by 25 per cent and that consumption would increase to the extent of 21 per cent so that the savings margin could be widened from 7 per cent of the national income, at the beginning of the plan, to 10 per cent at the end of it. In actual fact, however, real income has increased by only 10 per cent over the first three years of the Plan and the tax collections as a proportion of the national income has improved from 7.6 per cent in 1955-56 to 9.2 per cent in 1957-58.

But the feasibility of this scheme depends not only on the actual rate of growth of real income, but also on the particular pattern of investment and its distributional effects. The Second Plan has involved a considerable expansion of the public sector. Investment for investment, what is made in the private sector is capable of releasing in the short run a much larger volume of real income than is possible in the public sector. This disparity springs directly from the nature of the investment in the two sectors. Apart from the fact that the administrative cost per unit output tends to be higher in the public than in the private sector, there is the additional point that a large part of the investment in the private sector is for the development and expansion of consumer goods industries and as such results in the increase of final goods which match the release of purchasing power. It is also plausible to argue that had the public sector been confined to basic industries and the provision of social overheads, the expansion of the private sector, and the increase in output arising from it, could have been greater than what it has achieved. This by itself would have widened the tax base. On the other hand, in so far as government investment has a greater degree of inflationary potential and to the extent

the growth of the private sector has been restricted, the tax base is bound to be unresponsive in relation to the demands on it in the initial stages of development.

Other policies necessitated by government's development activity have also worked in the same direction. Thus, import restrictions which became inevitable in the context of balance of payments difficulties have adversely affected the yield of customs duties. And this decline has not to any appreciable extent been offset by the increased yield from excise taxation. It would appear that inflation resulting from deficit financing would bring about forced savings in the economy, and to the extent it fails to increase savings of this type the resources left with the public can be mopped up through borrowing and small savings. But it is clear by now that these sources also have failed to reach up to the targets. This is accounted for by the fact that while a part of these private savings find their way to banks and industries, a good portion gets invested in land and in the construction of building. Speculative bidding up of land values and increasing private expenditure on building construction which is conspicuously seen in the urban areas all over the country are indicative of the extent to which domestic resources have been utilized in investment which are non-productive from the national economic point of view.

With the domestic resources position rigid, the alternatives available are external finance and deficit financing. The Plan estimated a foreign trade deficit of Rs. 1,375 crores over the five years. But with exports showing a steady decrease and imports showing an equally steady rise, the trade deficit widened from Rs. 109.5 crores in 1955-56 to Rs. 464.3 crores in 1956-57, and Rs. 609.5 crores in 1957-58. It contracted a little to Rs. 470.4 crores in 1958-59. The availability of foreign loans and aid has eased the pressure considerably since then; but the position was quite serious in the first three years of the Plan and foreign exchange reserves had to be drawn upon to the extent of Rs. 522.9 crores in the years 1956-59. The pressure on foreign reserves was largely due to the excess demand created at home through deficit financing. According to the Planning Commission document entitled *Plan Resources and Outlay—A Review*, domestic resources accounted for 46 per cent of the total expenditure of Rs. 2,466 crores incurred in the first three years, external assistance 19 per cent and deficit finance 35 per cent. Of the total deficit of the

Centre and the States amounting to about Rs. 900 crores, by far the major part (about Rs. 830 crores) was covered by increase in the floating debt of the government with the Reserve Bank and a small part of about Rs. 70 crores was covered by withdrawal of cash balances. Thus, while in the First Plan about one-fifth of the total outlay was deficit financed, the proportion of this method of financing exceeded one-third of the total even at the end of the first three years of the Second Plan.

Deficit financing of this magnitude for investment purposes, in a brief span of about three years, is bound to have an inflationary impact on the economy. Since the close of the First Plan there has been a substantial increase in money supply with the public, attended with a marked rise in price level. It is, therefore, relevant here to assess the magnitude of inflationary pressures in the economy in the last two or three years and examine how far this situation was brought about by the method of financing adopted for development purposes.

### *Inflationary Pressures in the Indian Economy*

Between April 1956 and the end of June 1960 the general index number of wholesale prices (1952-53 = 100), has risen by 23 points—from 100.0 to 122.9. Basically a rise in the level of prices has to be explained in terms of an increase in demand in relation to supply. Hence a reliable general means of estimating the inflationary pressure in the economy is to find out the nature and size of excess demand operating in it. Aggregate demand in an economy in any given period is the sum of government spendings, private investment and consumption expenditure and balance of payments surplus on current account. Government's expenditure is equal to government's tax and non-tax revenues plus budget deficit. Normally, in the short period, government's tax and non-tax revenues and private consumption expenditure do not vary appreciably, but constitute a more or less fixed proportion of the total national product. But the other factors, size of the government's budget deficit, investment outlay in the private sector and surplus of the nation on current account vary from year to year, so that the magnitude of the excess demand in the economy at any point of time can be broadly equated to the government's deficit plus change in the level of private investment and change in the

surplus of the nation on current account. Variations in these three items are reflected, on the whole correctly, in changes in government's debt, in bank credit and in foreign exchange reserves respectively, so that a rough estimate of the excess demand in the economy can be made by making use of the data available under these heads. The figures in Table 40 relating to India for the period since 1955-56 give an idea of the situation in the country.

TABLE 40  
GOVERNMENT DEFICIT, BANK CREDIT AND FOREIGN  
EXCHANGE RESERVES, 1955-56 TO 1959-60  
(In crores of rupees)

| Year    | Government deficit | Bank credit | Foreign exchange reserves |
|---------|--------------------|-------------|---------------------------|
| 1955-56 | 184                | 761         | 825                       |
| 1956-57 | 309                | 900         | 681                       |
| 1957-58 | 496                | 963         | 421                       |
| 1958-59 | 331                | 1014        | 379                       |
| 1959-60 | 268                | 1128        | 363                       |

(Source: *Reports on Currency and Finance*, Reserve Bank of India.)

Government's deficit represents the extension of the Reserve Bank's credit to government and also investments by banks in government securities.<sup>1</sup> Bank credit includes bills purchased and discounted and advances made by the scheduled banks. The figures show that deficit spending by government increased rapidly in the three years 1955-56—1957-58 and declined in subsequent years. The steady expansion in bank credit in all the five years indicates increased investment activity in the private sector. Together they have exerted a considerable upward pull on the demand side. However, the continuous decline in the foreign exchange reserves should have helped in easing the inflationary pressures in the economy.

<sup>1</sup> Government's deficit in its transactions with the public is covered by resort to bank credit and from the point of view of its effect on money supply, this is defined to include not only extension of Reserve Bank credit to government (which takes the form of the purchase by the bank of government securities mostly ad hoc Treasury Bills and grant of loans and advances to government) but also investments by banks in government securities as well as changes in government balances. Reserve Bank of India, *Report on Currency and Finance*, 1958-59, p. 26.



Excess demand in the economy becomes effective by increased velocity of circulation of money or increase in the quantity of money or by both. As for the public sector, government can acquire more real resources for investment purposes by competing with private business, and if the demand of the government is in excess of what current income of the government would warrant, it would have to create money in order to bid successfully for the real resources available in the economy. This is what takes place when the government resorts to central bank credit, for the central bank is free to increase the volume of currency notes against government securities. Thus, the change in government's cash balances and its net borrowing or lending position with the central bank and the holding of government securities by the commercial banks not only reflect broadly the magnitude of financing done in this manner but also indicate the extent to which money supply has been increased. Bank advances to private sector represent in a sense deficit financing resorted to by the private sector and help in a further increase in money supply. For this reason, it is necessary to take into account borrowing from the commercial banks by the State and by private business together. Thus, if the government securities with the commercial banks increase and there is a decline in bank advances to private business to the same extent the net effect on money supply would be neutral. Another factor contributing to monetary expansion is the balance of payments surplus. In assessing the effect of excess demand in money supply it is important to consider all these three factors. Thus the rise in the volume of money with the public, from about Rs. 2,200 crores in 1955-56 to about Rs. 2,700 crores by the middle of 1960, i.e. an increase of 23 per cent, has to be considered as the net result of the expansionary force of government's budgetary deficits and credit expansion for the private sector and the contractionary effect of the decline in foreign reserves.

It should, however, be remembered that the total money supply of an economy is not necessarily directly proportional to the flow of money income. It is conceivable that even with an increase in money supply there would not be any effect on prices if people increase their hoarding of money. On the other hand, even in the absence of an increase in the volume of money, excess demand can become effective through increased velocity of circulation of money or fall in the liquidity preference of the people. When in financing its large investment outlays government puts more money into

circulation there may not be a proportionate increase in prices in the initial stages. If the people think that the rise in prices may be only temporary, they would rather stock the excess money than spend it. If, however, at a later stage their attitude changes and they start spending money for fear that its value in future would even be less, the uptrend in prices would be augmented both by increase in the volume of money and by the fall in liquidity preference. It is thus clear that in assessing the inflationary possibility of a given increase in the volume of money the liquidity preference factor has to be taken into account.

Liquidity preference may be roughly indicated as the ratio of money in circulation to money income. Thus if national income is Rs. 10,000 crores and money supply is Rs. 2,000 crores, the velocity of circulation of money is 5 and the liquidity preference  $1/5$ . The monetary statistics available in our country are quite detailed and up-to-date; but, since the National Income statistics are compiled with a considerable time lag, a computation of the liquidity preference of the people by the above method would not give a correct view of the position. It is, however, possible to find out whether there has been any change in liquidity preference over time by comparing the annual rate of increase in money supply with the annual rate of increase in prices. If the rate of increase in prices is higher than the increase in the supply of money, it means that liquidity preference has fallen and vice versa. The data contained in Table 41 throw some light on the matter.

TABLE 41  
VARIATIONS IN PRICE LEVEL AND MONEY SUPPLY

|                          | 1952-<br>53 | 1953-<br>54 | 1954-<br>55 | 1955-<br>56 | 1956-<br>57 | 1957-<br>58 | 1958-<br>59 | 1959-<br>60 |
|--------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Index of price           | 100         | 101.2       | 89.6        | 99.2        | 105.1       | 106.1       | 112.1       | 118.6       |
| Index of money<br>supply | 100         | 101.7       | 108.8       | 123.8       | 131.1       | 135.4       | 141.6       | 153.1       |

The indices of prices and money supply in recent years show that since 1955-56 there has been a considerable acceleration in the rate of increase in price level as compared with money supply.

Between 1957-58 and 1958-59, prices increased at a higher rate than the supply of money. The fall in the ratio of deposit money to monthly cheque clearings, from 1.3 in October 1957 to 0.9 in March 1958 and to less than 0.7 in March 1960, is another indication of increased velocity of circulation of money in the country.

### *Movement in Factor Prices*

The existence of excess demand and the increased velocity of circulation of money or fall in the liquidity preference of the people may be considered as rough indicators of inflationary pressures in the Indian economy. It is possible to notice some other symptoms also which lend support to this view. One is the trend in the prices of particular groups of articles. Inflation by its very nature is dynamic. At any particular period the price of any article or group of articles may go up due to temporary shortage in the supply of these commodities or an unexpected increase in the demand for them. But to the extent that rise in certain prices is due to continued relative shortage of a commodity and it adds to production costs, there is the possibility of price rise not only persisting but also getting accelerated in course of time. It is this sort of rise in prices that is of the inflationary type. For this reason, factor prices are particularly important in an analysis of inflation.

Wages are the price paid for labour. With increase in money incomes and rise in the prices of consumption goods and in the cost of living the general wage level tends to go up. In theory it is argued that there is a lag between wages and prices. The extent to which wages lag behind prices indicates how far the process of inflation has gone. If the rise in money wages is less than the rise in prices or cost of living there is a decline in real wages which represents forced savings brought about through inflation. But if money wages and prices move together without a lag or if wages take the lead, then it is certain that inflation has developed into an advanced stage. In India, in recent times, there has been a persistent demand of labour for higher money incomes while at the same time representatives of business complain that higher wages and higher costs of production are to a large extent responsible for higher prices of finished products. A comparison of the consumer price indices of working class in Bombay with the money incomes of workers

in the cotton textile mills in the same city<sup>1</sup> shows that in recent times money incomes are rapidly gaining on cost of living although there is no clear evidence to show that they have started to take the lead. The inference can be drawn that wage trend in India has reached a stage in which it is as much a cause as a result of inflation.

Speculative holding of goods also seems to be on the increase. Changes in government's import and export policy, fear of a short-fall in the supply of consumption goods and the general attitude of businessmen have certainly much to do with the speculative hoarding of commodities. But the really significant factor is the expectation of a further rise in prices resulting from inadequate supply and larger spendings in the economy. Hoarding, however, involves a cost in the form of interest to be paid on the money invested in the holding of stocks. So then, unless the expected rise in price is higher than the interest rate there would not be any tendency to stock commodities. If the rate of interest which the businessmen have to pay is 6 per cent and they expect a rise in the prices of goods which they stock by 4 per cent in one year then the real rate of interest is 2 per cent. The lower is this real rate of interest, the greater will be the propensity to hoard for speculative purposes. Recent trends in price level as well as interest rates in the country lead one to think that conditions have been quite favourable to this line of activity.

There are other prices which play a crucial role in the development of inflationary conditions in the economy. Thus, prices of food articles on which about 70 per cent of the average worker's income is spent, and a rise of which invariably necessitates a marking up of the wage rate as well and thus affects production costs and fosters an inflation of the cost push kind, have been going up steadily in the last few years. The index number of prices of food articles (1952-53 = 100) has risen from 94.6 in 1955-56 to 116.5 in 1959-60 and to 120.3 at the end of June 1960, representing a rise of 23 per cent in a little more than four years. Alongside of this there has been a spectacular rise in the prices of industrial raw materials since 1957-58, the index number of this being 142.0 in May 1960 against 112.9 in 1957-58. And this together with rise in wages has added substantially to production costs.

While the step up in development spendings has considerably

<sup>1</sup> *Indian Finance*, 18th October 1958.



increased effective demand, there has been no commensurate increase in output. Of particular significance in this context is the supply of food grains and industrial raw materials. Agricultural output in the country showed an actual decline in 1957-58 and the rise in 1958-59 is only a slight improvement over the position in the first year of the Second Plan. The same has been the trend in the output of other agricultural commodities and industrial raw materials. The index of industrial production registered a rise of only 7 points, from 132.6 to 139.7 between 1956 and 1958 (1951 = 100), but improved to 149.4 in January 1959. On the whole the inadequate response on the supply side may be said to have played a substantial part in pushing up the general price level in the country.

It would thus appear that there are unmistakable symptoms of inflationary pressures in our economy. And it has become increasingly apparent that the major cause of this disequilibrium is the method of financing adopted for development purposes. One significant fact is that the present phase in the rise of prices in India is different from the rise in the Korean boom. While in 1950-51, the sharp uptrend in price level was due mostly to an external factor, the forces responsible for the present rise are to be found in the country itself. Besides, while in the general rise in price level that happened about ten years ago it was manufactured articles that played the dominant part, at present, it is the rise in food prices and prices of industrial materials that has taken the lead.<sup>1</sup> The danger inherent in such a pattern of price trend should not be minimized.

The opposition to deficit financing springs mainly from the fear that unless it is kept within limits it is likely to lead to dangerous inflationary price trends. Deficit financing by government, in so far as it represents an investment outlay in excess of the receipts from current savings by way of taxation and loans, leads to an expansion of money incomes. The inflationary effect of this technique of finance arises from the fact that real incomes lag behind money incomes. It takes time for investment expenditure to fructify in the form of goods and services available for consumers. Besides, the fact that expansion of demand arising out of excess spending affects some groups of commodities and markets more than others, combined with lack of perfect mobility of the factors of production and the dangers of a wage inflation sprouting up in some sectors

<sup>1</sup> See Chart III, p. 72.

of the economy, add to the inflationary pressure which may be generated by deficit spending. It is for this reason that expansion of money, which is the frequent accompaniment of deficit financing, brings in its wake price rises long before a position of full employment has been attained.<sup>1</sup> The danger of such a situation is greater in an under-developed country than in a developed one.<sup>2</sup> However, against such a possibility it is worth while to keep in mind two important factors bearing on this problem. Firstly, deficit financing for economic development can never be so dangerously inflationary as for war purposes in so far as, in the latter case it is used for purely destructive purposes, while in the former it is designed to produce a larger stock of goods and services, which to a considerable extent mitigate the effects of increase in money supply. Secondly, while the possibility of a price rise consequent upon deficit financing even for development purposes cannot be disputed, it is necessary to set against this disturbance the problems of economic stagnation and backwardness which deficit financing attempts to remove.

So long as idle resources remain in an economy, deficit financing, while causing an increase in money supply, simultaneously draws into use unemployed resources and thereby raises the level of economic activity and real incomes. Thus in industrialized advanced countries, deficit financing was recommended and used as a means of creating effective demand in a period of depression and thereby helping the country to get over the crisis. In so far as in such countries supplies of complementary productive factors are in good array, production easily responds to larger investments, so that credit creation or deficit financing does not lead to any dangerous price inflation. In an undeveloped country there are certain factors which restrict the chances of inflation arising from deficit financing, but there are also opposing forces which considerably limit the economy's capacity to absorb deficit financing. In such an economy, the lack of skilled labour and capital, the relatively small size of the fixed income class through which real resources are transferred to government for developmental purposes, and the high propensity to consume are factors which would help in a rise in price level if there is deficit financing. On the other hand, the habit of hoarding, the limited scope for credit expansion, and the difficulty of price rise to move from one region to another in the absence of adequate

<sup>1</sup> Seymour E. Harris, *National Debt and the New Economics*, 1947, p. 122.

<sup>2</sup> See Chapter I, pp. 9-15.

communication facilities, are factors working in the opposite direction.<sup>1</sup> Generally speaking, the inflationary effects of developmental expenditure based on deficit finance depends on the time lag between investment expenditure and the consequent increase in output; the longer is this interval, the greater is the chance for inflationary price rise.

But in an under-developed country, where large annual investments are made for the purpose of raising national income, a certain rise in prices is as inevitable as it is beneficial. A modest rise in prices, provided it is free from any violent fluctuations, acts as a mild stimulant to economic activity. Furthermore, if in an economy when the level of investment rises, and voluntary savings or compulsory savings through taxation fail to increase correspondingly, deficit financing, by causing a rise in prices, serves a useful purpose in filling the gap between savings and investment via what may be called forced savings. But rise in prices beyond a limit is to be carefully guarded against in so far as it causes much hardship to fixed income earners, promotes social discontent and seriously hampers development efforts.

Expansion of money supply, which will be necessitated by deficit financing, will lead to an inflationary trend in prices only if it is more than enough to finance the larger volume of production, consumption and investment at stable prices. Thus, so long as production is increasing and the level of investment and consumption is rising, a commensurate rise in prices should be considered as essential to the proper functioning of the economy. The issue of the inflationary impact of deficit financing, therefore, hinges on the question as to what extent the expansion of money supply involved in deficit financing is necessary or excessive in relation to the demands for it. When the Second Five Year Plan was launched the opinion was expressed by some competent authorities that deficit financing of the order of Rs. 1,200 crores would be too much for the Indian economy to bear. In the First Plan period nearly one per cent of the national income was deficit financed; in the Second Plan this ratio would rise to two per cent. The Economic Commission for Asia and the Far East, therefore, considered that Rs. 1,200 crores should be taken as the outside limit to deficit financing during the Second Plan period; to raise the sum further might leave a large quantity of excess purchasing power without any

<sup>1</sup> F. Benham, "Deficit Finance in Asia", *Lloyds Bank Review*, January 1955.

corresponding cover.<sup>1</sup> In his Report on Tax Reform in India, Professor Kaldor stated that "the amount of deficit financing which the economy can absorb is not likely to exceed Rs. 150 crores a year or say Rs. 800 crores over the five year period."<sup>2</sup>

For this reason, the present change in the attitude of the Planning authorities to deficit financing should be considered as welcome. The inflationary impact of the heavy budgetary deficits in the first two years of the Second Five Year Plan amounting to about Rs. 700 crores was largely offset by the balance of payments deficits financed out of foreign exchange reserves; and as such with the rapid decline of these reserves to near the minimum required for operational purposes, the need has been felt to reduce deficit financing drastically.<sup>3</sup> Accordingly for the last two years of the Plan, 1959-61, budgetary deficits have been put substantially lower at Rs. 210 crores making a total of Rs. 1,092 crores at the end of the Plan.<sup>4</sup> For this reason this method of financing has been assigned a much smaller part in the Third Plan. According to the Draft Outline of the Third Five Year Plan, the total investment outlay is to be of the order of Rs. 10,200 crores, of which outlay in the public sector would be Rs. 7,250 crores. The limits of deficit financing are indicated with reference to its effect on money supply. It is assumed that the "money supply could increase by about 33 per cent in the Third Plan period without causing excessive pressure on prices". On this basis the additional money creation permissible in the Third Plan period is estimated at Rs. 950 crores. Allowing for the fact that part of the increase in money supply comes through the banking system, the amount of budgetary deficits that could be considered permissible for the Third Plan period is taken at Rs. 550 crores.<sup>5</sup> This would mean that deficit financing in the Third Plan would account for 7.6 per cent of the total outlay in the public sector against about 24.4 per cent in the Second Plan.

This is very modest indeed. But it must be observed that deficit

<sup>1</sup> United Nations, *Economic Survey of Asia and the Far East*, 1955, p. 112.

<sup>2</sup> Nicholas Kaldor, *Indian Tax Reform—Report of a Survey*, Ministry of Finance, Government of India, 1956, p. 1.

<sup>3</sup> Planning Commission, Government of India, *Appraisal and Prospects of the Second Five Year Plan*, May 1958.

<sup>4</sup> Reserve Bank of India, *Report on Currency and Finance*, 1959-60, p. 58.

<sup>5</sup> Planning Commission, Government of India, *Third Five Year Plan—A Draft Outline*, June 1960, p. 49.



financing can be kept within this limit only on the assumption that other resources turn out to be as high as they are expected. It is estimated that additional taxation excluding measures to increase the surpluses of public enterprises would bring in Rs. 1,650 crores and external assistance would be available to the extent of Rs. 2,200 crores, i.e. 22 per cent and 30.3 per cent respectively of the total outlay. The targets of these resources appear to be rather too optimistic and to the extent there is a short-fall in the yield from these sources, either the Plan would have to be scaled down or the level of deficit financing would have to be raised. Also the argument underlying the assumption on which the limits of financing development by this method are fixed, viz. that the capacity of the economy to absorb deficit financing has to be judged with reference to its effect on money supply rather than its capacity to increase output in relation to the excess demand created by it, seems unsound.

## CHAPTER VIII

### BALANCE OF PAYMENTS AND PRICES

#### *Meaning and Significance of Balance of Payments*

OF EQUAL significance as government spendings in influencing price level in a country are changes in the balance of payments. Normally, a favourable balance of payments position has an inflationary effect on the national economy, while a deficit has a deflationary effect.

Broadly speaking, balance of payments constitutes a financial record of all payments made by people of one country to people of other countries and also payments received from people in other countries in a given period. In this respect, it constitutes a national income statement, indicating the sources and size of the income of a country from abroad as well as the expenditure which that country incurs abroad. These financial transactions detailed in a Balance of Payments Statement are usually classified into the following groups:

- (a) Payments arising from the export and import of tangible things like merchandise and valuable metals. These constitute what are known as the visible items of trade and form by far the largest item among the several transactions.
- (b) Payments arising from services rendered to foreign nationals as well as payments due to peoples in foreign countries on account of services rendered by them. These form what are called the invisible items of trade and comprise such items as expenditure of tourists and emigrants, shipping charges, interest and dividend payments, bankers' and brokers' commission, royalties for motion pictures, patents and copyrights, etc.
- (c) Unrequited transfers, i.e. payments made or received for no simultaneous flow of goods or services, like official or private donations or charities, gifts, reparations, indemnities, etc.

These three items constitute the current account or income account in the balance of payments. It is easy to see that in any country in

a given period of time, such as a year, the receipts under these three heads, i.e. visible trade, invisible trade and unrequited transfers, may not be equal to the payments which have to be made under the same heads to other countries. The country then has either a surplus or a deficit in its balance of payments. This surplus or deficit will be offset by the movement of short-term and long-term capital and also of monetary gold shown in the capital account of the balance of payments. Thus, if a country has a deficit in its balance of payments, this deficit will be covered by drawing on its foreign exchange reserves, by borrowing from foreign countries for this specific purpose, or by exporting gold. Transactions of this kind represent what is called net foreign disinvestment of the country having a balance of payments deficit. The International Monetary Fund uses the term "compensatory financing" to denote such transactions. Since capital disinvestment would be just so much as to cover the deficit in the current account, it would be found that when the two accounts, current and capital, are taken together, there is an exact balancing of the two sides. This is obviously due to the fact that such a statement merely mentions on one side all the sources from which foreign purchasing power was acquired by the country and on the other side enumerates the ways in which the foreign purchasing power was used. But in actual fact, the term "balance of payments" is understood to mean the deficit or surplus shown in the current or income account.<sup>1</sup>

Balance of payments position has a close bearing on the economy of a country. It affects the level of economic activity, the size of output and national income and the price level. However, the views of economists on the question of the relationship between balance of payments and an important aspect of economic activity, namely, price level, have undergone a significant change in recent years. According to the classical writers, balance of payments has a direct bearing on price level as a result of its influence on money supply. Thus, disturbances caused by any shift in the balance of payments of countries would be settled by price changes on an international level which would restore equilibrium. Under gold standard, the necessary adjustments in international payments items would be

<sup>1</sup> Prof. J. E. Meade uses the terms *autonomous payments* to denote payments made on the current account and *accommodating payments* to denote those made in order to cover the deficit in the current account. *The Balance of Payments*, 1951, p. 15.

brought about by means of specie flows—prices rising in gold importing countries and falling in gold exporting countries. Even under an inconvertible standard, the same principle was assumed to operate. Thus the Purchasing Power Parity theory attempts to explain that international payments will be kept in balance by variations in merchandise trade, which is assumed to be sufficiently flexible for the purpose.<sup>1</sup> In other words, whether under the gold standard or under inconvertible paper standard, relative changes in the balance of payments of different countries would have a direct effect on the money supply of the country and thereby affect price level in the country. But in the face of modern developments, the Purchasing Power Parity theory has lost much of its validity. It does not take into account the fact of economic controls which keep down prices artificially and at the same time prevent the free movement of merchandise. Apart from this, its failure to recognize the importance of relative elasticities of demand for imports in different countries and the significant part played by capital movements is another serious defect.

On the other hand, the modern view influenced largely by the writings of Lord Keynes is that balance of payments changes affect directly the national income and through it, influence prices. Normally the exports of a country are balanced by its imports. Since payments have to be made for the imports, the net additional income earned through foreign trade is the difference between the value of exports and imports. If exports exceed the imports of a country and the country has a surplus balance of payments, this excess is treated as investment for national accounting purposes. Thus, total investment of a country in a given period is the sum of domestic investment and foreign investment in the form of a surplus earned in international trade. Realized savings are necessarily equal to realized investment. Hence income minus consumption is equal to domestic investment plus foreign investment. Therefore, when balance of payments is in equilibrium, it means that there is neither excess investment or savings arising out of foreign trade. But if there is a balance of payments surplus there is excess investment which will have an inflationary or expansionary effect; and a balance of payments deficit is of the nature of excess savings and will have the opposite contractionary effect. Thus disturbances in the equilibrium of international balance of payments tend to be re-

<sup>1</sup> H. B. Killough, *International Trade*, 1938, p. 328.



moved and equilibrium restored as a result of the effect of balance of payments on economic activity and income. Professor Meade in his recent book *The Balance of Payments* points out that balance of payments of a country is influenced by numerous factors, such as elasticity of demand for imports and elasticity of supply, increase in productivity, foreign transfers, reparation payments and tariffs, changes in wage, interest and exchange rates, speculative activity, etc. In a neutral economy in which these factors are assumed to be constant, an increase in domestic expenditure leads to some increase in national income, employment and output. In so far as some of the goods consumed in this country are imports, an increase in the income of this country will lead to increased demand for imports and thereby generate income in the country from which imports are obtained. Thus, as between two countries *A* and *B*, increased domestic expenditure in *A* raises national income and prices in that country. To the extent that increased income in *A* leads to larger imports from *B* inflation is exported to *B*. This sets in motion a multiplier effect in *B* as a result of which there is increase in imports into *B* from *A* which prevents balance of trade of *A* from being as unfavourable as it would otherwise be. After a series of repercussions like this, a new equilibrium will be established. A fall in expenditure operates in the reverse way.

The main merit of this approach to the problem is that it recognizes the inter-dependence of balance of payments position on the one hand and national income and price level on the other. A higher level of investment in one country raises the level of income and under certain conditions pushes up the price level also. But both the rise in the level of income and in price level are to some extent counteracted by the increased demand for imports. Increase in imports generates income in the foreign countries. Thus balance of payments deficit, occurring at a time when domestic investment is rising offsets to some extent the inflationary impact of such investment. If the higher level of investment arises externally, i.e. through an export surplus caused by greater demand for the country's exports, as happens during a war boom, it will have the same effect as a rise in domestic investment.

It is true that excess spending or excess demand creates an adverse balance of trade. But if excess demand is to be effective, excess supply of money either in the form of an increase in the quantity of money or in the form of an accelerated velocity of circulation of the

existing stock of money is needed. It has been shown that in Great Britain in the post-war period "the continued existence of a redundant supply of loose money has been a standing menace to the balance of payments as well as the stability of money".<sup>1</sup> It is, therefore, worth while to examine the relationship between the balance of payments position and money supply in a country.

External payments are made through the agency of banks. If in any year one country *A* has a surplus balance of payments of say \$ 10 million against *B*, it means that exporters in *A* have claims of the value of \$ 10 million on importers in *B*. Thus *A*'s exporters are creditors and *B*'s importers are debtors. The creditors in *A* will sell their claims on foreign currency to the banks in their own country and get from those banks their own currency. These constitute the liabilities of banks in *A* to the creditors who are their customers. On the other side, importers in *B*, in order to make the payments to their external creditors, would be drawing on their balances with their banks. In effect, the deposits of the value of \$ 10 million in country *B* are due to the banks in *A* and not to the importers in *B*. Thus, while the liabilities of the banks in country *B* remain the same, the purchasing power at the hands of the debtors in *B* in the form of deposits with their banks will have declined by \$ 10 million.

This, however, is the first stage. The commercial banks in country *B* meet the claims of the commercial banks in country *A* by drawing upon their balances with their central bank. As a result, the deposits of the commercial banks in country *B* with the central bank in *B* will decline by \$ 10 million, while the funds of the commercial banks in *A* with the central bank in *B* will increase by \$ 10 million. The net result can be summarized as follows:

(1) The deposits of creditors in country *A* with their commercial banks have increased by \$ 10 million; that is, the liabilities of commercial banks in *A* have increased by \$ 10 million. To that extent purchasing power of the residents in *A* is increased.

(2) The funds held by commercial banks in *A* with the central bank in *B* have increased by \$ 10 million. This constitutes their assets against their new liabilities.

(3) The deposits of commercial banks in *B* with the central bank in *B* have fallen by \$ 10 million. Simultaneously the deposit

<sup>1</sup> R. G. Hawtrey, *The Balance of Payments and the Standard of Living*, 1950, p. 38.

liabilities of the commercial banks in *B* to their own customers are down by \$ 10 million. To that extent purchasing power in *B* has declined.

In so far as the deposits of commercial banks in *B* with their central bank constitute their "cash", the effect of this transaction is that there is an equal fall in cash and in deposits, i.e. deposits of the customers of the banks in *B*. This reduces the cash ratio of the commercial banks in *B*. To replenish their cash and restore the normal ratio, they have to dispose of their short-term securities and if the tendency for a run of their balances with the central bank persists, they will have to sell their long-run government securities as well, in which case their prices will be brought down and interest rates will be pushed up. Thus the final effect of an adverse balance of payments for *B* with *A* is tighter money conditions in *B*, shrinkage in the volume of purchasing power and at the same time increase in the purchasing power in *A*.

It should, however, be added that what has been outlined above is the effect of balance of payments changes on the assumption that they are not offset by countervailing factors. One important countervailing factor is the budgetary position of the government. We have seen how deficit in the balance of payments of *B* leads to a fall in the deposit liabilities of the commercial banks in *B*. If at the same time the government has a deficit of the same amount, government will have to draw on the central bank to meet the deficit, which would result in the increase in the deposit liabilities of the commercial banks in *B* as well as in their deposits with the central bank. But in the absence of contrary budgetary changes and the adoption of any neutralizing measures, such as, for example, the maintenance of an Exchange Equalization Account, a surplus in balance of payments would lead to expansion of purchasing power and a deficit would cause contraction in purchasing power.

An accurate balance of payments statement shows the income which a country obtains in a particular period of time from foreign sources. It is therefore of equal importance as the National Income Computation as a basis for policy making. Being a record of outlay and incomes, it reflects like the National Income data, the nature and standard of the economy to which it relates. Thus there are certain special features in the balance of payments data of an under-developed country which distinguish it from that of an advanced economy. The balance of payments difficulties of most of the less

developed countries can be attributed to certain internal as well as external factors. Among the domestic factors, the most important are changes in price level, increase in population and structural imbalances resulting from disparity in expansion as between industries and agriculture, between the public and private sectors and between industries.

The great interest taken by governments in these countries to accelerate economic development has involved inflationary methods of financing which while helping in an increase in real incomes has resulted invariably in a greater increase in money incomes. A rise in real income raises the standard of life of the people, increases their capacity to consume, facilitates larger investment and thereby causes a greater demand for both consumption and investment goods; but if money income rises faster than real income—and this is the characteristic of inflation—excess demand creates a strain on domestic resources as well as on foreign balance. The transfer of money incomes to richer classes brought about by inflation causes an increase in the demand for imported luxury articles. And if the importation of such goods is restricted or stopped, domestic resources tend to be diverted to industries producing similar goods with the result that the output of exportable goods suffers. Or if it results in a decline in the resources necessary for the production of necessary consumption goods the shortage in this would aggravate inflationary pressures along the usual wage cost line. The ultimate effect of such developments is external payments difficulties and decline in foreign balances.

Apart from inflationary methods of financing economic development, pressure on balance of payments is exerted through increased demand arising from growth of population. In most of the under-developed countries the rate of growth of population is high. Since capital is scarce, growth in numbers increases unemployment, reduces productivity, keeps down per capita incomes and prevents a widening of the savings margin which is essential for raising the level of income. On the other hand, there is need for additional food supplies and if conditions of domestic supply are inelastic, more and more imports become necessary with obvious effect on foreign balances. This has been well illustrated by recent trends in India.

Sponsored economic growth in under-developed countries has also involved the development of some industries whose potentiality



for growth is great or the development of which indirectly benefits other industries and thereby generates growth forces. But this artificial stimulus given to particular industries has a direct adverse effect on foreign balances. If the industry to which support is given is not an efficient one, protection raises costs and prices and thus hampers the expansion of other industries which are export oriented and which depend on the protected industry for their raw materials. The higher cost of raw materials adds to the cost of production and prices of export goods and affects their exports.

Among the external factors that affect the balance of payments position of under-developed countries may be mentioned the nature of the demand for the export goods of these countries in industrial countries, the influence of economic fluctuations in the latter on the former, and the reliance of the less developed countries on foreign capital. Firstly, the elasticity of demand for the export products of under-developed countries in the industrially advanced countries is greater than that for the export products of the developed countries in the poorer countries. Industrialization in these countries necessitates the importation of capital goods, the need for which increases with the progress of the economy. On the other hand, the import of agricultural products into industrial countries tends to decline progressively as their income grows. One reason for this trend is that these countries are taking steps to make themselves less dependant on other countries in the matter of raw materials by economizing in the use of such goods and by developing many synthetic substitutes. There has been a secular trend for income in industrial countries to go up at a much faster rate than incomes in primary goods producing countries so that the exports of the latter form a smaller and smaller proportion of the national incomes of the former. For these reasons there has been a tendency for the prices of agricultural commodities to decline in relation to industrial goods. This adverse trend in the terms of trade is another factor which has hit hard the poorer countries in the matter of their external payments position.

Secondly, the foreign trade of under-developed countries is very much susceptible to cyclical changes in the incomes of industrial countries. This is largely due to the fact that the degree of concentration of exports is greater in the less developed countries of the world than in the economically advanced ones. Roughly 90 per cent of the foreign exchange earnings of the former are derived

from the export of primary products. Since the ratio of their export earnings to national income is large, any variation in the demand for their exports will have a serious repercussion on their incomes. This explains why cyclical fluctuations in a large industrial country like the U.S.A. produce similar income changes in countries which are exporting primary commodities to the U.S.A. Lastly, backward countries are, as a rule, capital importing countries as against countries like the United Kingdom and the U.S.A. which export capital. The large foreign investments in East Asiatic countries in the pre-war period constituted heavy annual liabilities for them and necessitated the maintenance of an export surplus with which to meet the payments on account of invisible items. Since the end of the war, large deficits in their balance of payments have been covered by drawing on "foreign" balances and also by obtaining foreign loans.<sup>1</sup> The advancing of loans to under-developed countries and the investment of foreign capital involve a demand for the currency of these countries and help in its appreciation. But the application of this foreign capital for development purposes generates income in the under-developed countries and pushes up the price level and leads to greater demand for imports, which to some extent offsets the effect of the initial currency appreciation. However, the tendency for a cumulative movement of long-term capital imports into these countries in times of world prosperity and a reverse trend involving sometimes a net repatriation of foreign capital in periods of world depression adds to the instability of their economy.<sup>2</sup>

#### *Trends in the Balance of Payments in India*

The Reserve Bank of India started collection of balance of payments data some time after the close of the Second World War and published in July 1949<sup>3</sup> balance of payments information relating to the years 1946 and 1947, the first of its kind in India. But it was admitted that the statistical details were far from being accurate and would serve only as a means of making a rough estimate of the actual trend in the balance of payments in the country. One serious gap in the current account was the lack of

<sup>1</sup> United Nations, *Economic Survey of Asia and the Far East*, 1947, pp. 220-22.

<sup>2</sup> T. C. Chang, *Cyclical Movements in the Balance of Payments*, 1951, p. 20.

<sup>3</sup> *Reserve Bank of India Monthly Bulletin*, July 1949.

accurate information relating to the foreign liabilities of the banking system. Besides, the data available for 1946 and 1947 are not strictly comparable with that for subsequent years because of differences in coverage, timing and valuation. Details for 1946 and 1947 relate to the whole of India before Partition; for the later years, the balance of payments statements are confined in scope to the territory of the Indian Union and up to 1951 exclude also the exchange transactions of India with Pakistan.<sup>1</sup> Some discrepancies have also arisen as a result of the fact that in the earlier years different sources were made use of for the collection of figures. The 1946 data was compiled from the Customs Returns, from the Reserve Bank and Government Accounts and also from the Exchange Control Department. In 1947, greater reliance was placed on the information available from the Exchange Control Department and in the subsequent years the calculations have been based uniformly on the records of the Exchange Control Department. There is discrepancy between the figures compiled from the Customs Returns and those from the records of the Exchange Control Department, which has to be explained by the time factor in recording transactions and by the difference in the valuation of merchandise. These defects have, however, been gradually removed in subsequent years, and the balance of payments statements from the year 1948 have attained a fairly high standard of accuracy.

Between 1939 and 1945 India had a large favourable balance of trade on private and government account. This was partly due to the favourable balance on visible account and partly to the expenditure incurred by allied armies locally in India and the expenditure incurred by the Government of India on behalf of and recoverable from the United Kingdom Government. Table 42 illustrates India's visible balance of trade during the war-period.

Since the outbreak of war and up to the end of the financial year 1945-46, recoverable war expenditure amounted to about Rs. 1,740 crores. A good part of the visible balance of trade enjoyed by the country during the war period was utilized for repatriating India's external public debt of the face value of £320 million at a cost of about Rs. 425 crores.

<sup>1</sup> Since 1952 exchange transactions with Pakistan have been included in India's Balance of Payments Accounts.

TABLE 42

## INDIA'S VISIBLE BALANCE OF TRADE, 1939-45

(In lakhs of rupees)

| Year    | Merchandise |        |                  | Treasure |        |                  | Total visible balance of trade |
|---------|-------------|--------|------------------|----------|--------|------------------|--------------------------------|
|         | Export      | Import | Balance of trade | Export   | Import | Balance of trade |                                |
| 1939-40 | 21595       | 16897  | 4698             | 4079     | 664    | 3415             | 8113                           |
| 1940-41 | 20044       | 16129  | 3915             | 1855     | 324    | 1531             | 5446                           |
| 1941-42 | 25446       | 17475  | 7971             | 1221     | 434    | 787              | 8758                           |
| 1942-43 | 19517       | 11671  | 7846             | 1080     | 63     | 1017             | 8863                           |
| 1943-44 | 21109       | 13273  | 7836             | 572      | 367    | 205              | 8041                           |
| 1944-45 | 22898       | 23194  | -296             | 518      | 2446*  | -1928            | -2224                          |

\* Due mainly to imports from the U.S.A. of Lend-Lease silver on government account to the value of Rs. 1,825 lakhs.

(Source: *Report of the Fiscal Commission, 1949-50, Vol. I, para 134.*)

Balance of payments trends in India in the post-war period have five distinct phases:

- (a) Deficits up to the third quarter of 1949.
- (b) Surpluses from the fourth quarter of 1949 to the middle of 1951 caused by devaluation and military flare-up in Korea.
- (c) Deficits from the middle of 1951 to the middle of 1952—slackening of war demand.
- (d) Favourable balance of payments since the middle of 1952, and up to 1955-56.
- (e) Adverse trends in the Second Plan period.

The quarter-end figures in Table 43 illustrate these main trends.

(a) *Deficits, 1946-49*

At the close of the war, conditions seemed favourable to India's foreign trade. The price of primary products, which still formed a good proportion of Indian exports, had fully recovered from the crash in the previous decade. Besides, the clearance of the large volume of sterling debts on official account and the accumulation



TABLE 43

INDIA'S BALANCE OF PAYMENTS—CURRENT TRANSACTIONS  
(In crores of rupees)

| Year             | Net surplus (+) or deficit (—) | Year             | Net surplus (+) or deficit (—) |
|------------------|--------------------------------|------------------|--------------------------------|
| 1946             | — 36.4                         | 1954 1st quarter | + 18.9                         |
| 1947             | —154.0                         | 2nd quarter      | — 14.6                         |
| 1948 1st quarter | + 16.1                         | 3rd quarter      | — 14.8                         |
| 2nd quarter      | + 16.7                         | 4th quarter      | + 10.5                         |
| 3rd quarter      | — 82.7                         | Total            | 0.0                            |
| 4th quarter      | — 45.9                         |                  |                                |
| Total            | — 96.0                         | 1955 1st quarter | + 27.2                         |
| 1949 1st quarter | —102.1                         | 2nd quarter      | 0.0                            |
| 2nd quarter      | — 78.6                         | 3rd quarter      | — 0.5                          |
| 3rd quarter      | — 29.5                         | 4th quarter      | + 16.6                         |
| 4th quarter      | + 42.6                         | Total            | + 43.3                         |
| Total            | —167.4                         | 1956 1st quarter | + 4.6                          |
| 1950 1st quarter | + 30.5                         | 2nd quarter      | — 44.5                         |
| 2nd quarter      | — 19.2                         | 3rd quarter      | — 81.4                         |
| 3rd quarter      | + 10.5                         | 4th quarter      | — 84.8                         |
| 4th quarter      | + 48.2                         | Total            | —206.1                         |
| Total            | + 70.1                         | 1957 1st quarter | — 81.8                         |
| 1951 1st quarter | + 22.0                         | 2nd quarter      | — 84.7                         |
| 2nd quarter      | + 11.7                         | 3rd quarter      | —138.5                         |
| 3rd quarter      | — 14.2                         | 4th quarter      | — 72.4                         |
| 4th quarter      | — 50.8                         | Total            | —377.4                         |
| Total            | — 31.3                         | 1958 1st quarter | — 81.0                         |
| 1952 1st quarter | — 75.4                         | 2nd quarter      | —120.2                         |
| 2nd quarter      | — 5.4                          | 3rd quarter      | — 90.6                         |
| 3rd quarter      | + 11.4                         | 4th quarter      | — 63.0                         |
| 4th quarter      | + 32.0                         | Total            | —354.8                         |
| Total            | — 37.3                         | 1959 1st quarter | — 65.0                         |
| 1953 1st quarter | + 14.1                         | 2nd quarter      | — 76.4                         |
| 2nd quarter      | — 10.4                         | 3rd quarter      | — 52.0                         |
| 3rd quarter      | + 0.8                          | 4th quarter      | + 21.7                         |
| 4th quarter      | + 52.4                         | Total            | —171.7                         |
| Total            | + 56.9                         | 1960 1st quarter | — 74.1                         |

(Source: "Post-War Balance of Payments in India", *Reserve Bank of India Bulletin*, July 1949 and June 1956. *India's Balance of Payments*, 1948-51, Reserve Bank of India (Reports on currency and finance). Figures for 1946-47 relate to undivided India; those for 1948-51 exclude Pakistan and figures for 1952-56 include Pakistan.)

of a pile of sterling assets brought down considerably the net transfers from India on account of service payments. In spite of this favourable situation, the country came to experience a series of balance of payments deficits since the close of the war up to the last quarter of 1949. This was due to certain new factors which had developed during this period. The large volume of purchasing power in the hands of the people, which had been held down by a system of strict controls during the war period, exerted a pressure on the demand for imports soon after the end of fighting. The liberalization of the import policy by the government by the middle of 1947 is reflected in the payments on account of import of merchandise which went up from Rs. 388.7 crores in 1946 to Rs. 534.7 crores in 1947. In the first half of 1948 there was in fact a net surplus on current account, but as a result of the further relaxation of import controls following the Indo-U.K. Agreement of July 1948 the current account for the second half of 1948 showed a deficit of Rs. 128.6 crores. These deficits continued in the first half of 1949. Between January 1949 and May 1949 imports rose progressively up to nearly Rs. 60 crores a month and exports declined to Rs. 26 crores in May 1949 against the monthly average of Rs. 46 crores during the first half of 1948.

The relative inelasticity in the demand for imports played a prominent part in determining the balance of payments position. With the partition of the country and the unfavourable political developments, import of food into India had to be considerably increased. The import of food, which did not exceed an annual average of about 0.5 millions tons per annum, rose to more than five times of this in the immediate post-war period. Large imports of food had become a recurring feature of the post-war foreign trade. Almost equally inelastic was the demand for certain types of machinery for replacement and development purposes. The fact that food had to be imported mostly from hard currency areas very much worsened the balance of payments position of India *vis-a-vis* that group of countries and brought into prominence the problem of dollar deficit. During the six months, April to September 1948, out of the total dollar deficit of 45 million dollars, purchases of foodgrains accounted for as much as 35 million dollars. In fact, during the period after the end of the war and up to the last quarter of 1949, hard currency deficits of India constituted nearly the entire balance of payments deficits of the country.

Against an increase in imports, there was a sharp decline in the export of commodities like jute, tea and manganese to the hard currency areas. Although this was compensated by an increased export of these commodities to soft currency areas, yet the deflection of this export largely aggravated the difficulties with the hard currency areas. With the onset of a mild recession in America in 1948-49 and the rise in the price of Indian goods following decontrol, American demand for Indian goods fell sharply. Among the factors which account for the failure of Indian exports to keep pace with imports may be mentioned the low level of production, shift of production from exports to home goods, transport bottlenecks and high costs, increased internal consumption of export goods and export duties.

One other factor responsible for the adverse turn in the balance of payments was the disappearance of the receipts on account of expenditure incurred on behalf of the United Kingdom. In 1946 India still received a substantial amount under this head and this created a favourable balance in respect of services. But in the next year the position changed abruptly and the pre-war feature of a regular deficit on account of service items reappeared in a somewhat less serious form.

How then was this large balance of payments deficit in the years 1946-49 financed? A deficit on the current account in the balance of payments of a country will be covered by (1) foreign grants, donations and other receipts, and also by (2) official utilization of foreign balances of the country. The latter method of financing a deficit has come to be known as compensatory official financing to be distinguished from special official financing which covers the former. Compensatory official financing has two distinct features: firstly, the financing is to be done officially; secondly, financing is to be done with the definite purpose of covering the deficit in the balance of payments. As regards India, the main items included under the category of compensatory official financing are (1) movement in the sterling balances of India which constitute the bulk of the exchange reserves available to the country, (2) changes in the balances of purchasing missions and embassies abroad—the balances with the India Supply Mission in America and that with the High Commissioner in London, (3) variations in the foreign balances of the Indian commercial banks in so far as transactions of such foreign balances are subject to the overall control of the exchange authorities

in India, (4) use of the resources of the International Monetary Fund to cover balance of payments deficits as was done in 1948 and 1949 and drawings on the U.S. Food Loan. Thus, in the absence of a well-developed short money market at home, India has to rely mostly on international cash reserves for balancing purposes.

As mentioned above, the balance of payments deficit of India in 1946-49 was almost entirely a deficit with the hard currency area. In the first two years of the post-war period, this deficit did not constitute a serious problem so far as payment was concerned, because then the convertibility of sterling balances was not strictly limited. But the sharp fall in the central reserves of the Sterling Area in 1947 necessitated the fixation of a ceiling on convertibility early in 1948. Thus the drawing of the Indian Union on the sterling balances was restricted to £10 million in the first half of 1948 and £15 million in the period July 1948 to June 1949. However, the need for importing food and locomotives from the U.S.A. and Canada to ease the food and transport situation at home maintained the level of government expenditure on imports from hard currency areas at a high level. In consequence, the deficit on the import of merchandise on government account amounted to Rs. 89.5 crores in the third quarter of 1948<sup>1</sup> and Rs. 36.3 crores in the fourth quarter of 1948. The first half of 1949 also showed deficits on this account of about the same magnitude. Since the release from the central reserves of the Sterling Area could not meet this deficit, India had to borrow from the International Monetary Fund about \$100 million up to the end of March 1949. Thus the main sources for compensatory financing available and made use of during this period were the release from the sterling balances of the country and the facilities offered by the International Monetary Fund. This is shown in Table 44.

(b) *Surpluses, 1949-51—Devaluation and the Korean Boom*

One important cause of the fall in Indian exports after the end of war was that prices in India had risen to a considerably higher level than in some other countries which constituted a substantial section of the markets for Indian exports. In the eight months preceding devaluation, the rise in the general level of prices in India

<sup>1</sup> Includes barter deals, loans to foreign governments, rupee securities held by foreign official institutions, etc.



TABLE 44

FINANCING OF THE BALANCE OF PAYMENTS DEFICIT, 1946-49  
(In crores of rupees)

|  | 1946   | 1947   | 1948    | 1949   |
|--|--------|--------|---------|--------|
| 1. Total deficits requiring financing                                  | — 66.0 | —208.9 | —335.4* | —185.0 |
| 2. Errors and omissions  | + 7.3  | + 97.5 | — 56.7  | + 16.2 |
| 3. 1 plus 2  | — 58.7 | —111.4 | —392.1  | —168.8 |
| 4. Compensatory official financing:                                    |        |        |         |        |
| (a) Use of IMF resources   | —      | —      | + 22.7  | + 10.5 |
| (b) Foreign exchange assets (including reduction in sterling balances) | + 56.9 | +107.5 | +354.0  | +158.2 |
| (c) Other items  | + 1.8  | + 3.9  | + 15.4  | + 0.1  |
| 5. (a) plus (b) plus (c)   | + 58.7 | +111.4 | +392.1  | +168.8 |

\* Includes purchase of pensions annuity (Rs. 224 crores) and purchase of defence stores (Rs. 60 crores).

(Source: "Post-War Balance of Payments of India", *Reserve Bank of India Bulletin*, July 1949; *India's Balance of Payments, 1948-51*, Reserve Bank of India.)

was more than 75 per cent higher than in the U.S.A. The large import of foodstuffs combined with the hampering of exports by inflation and currency overvaluation worsened the balance of payments position. Devaluation had therefore become necessary as a defensive measure to countries like India. By devaluing the currency it was possible to adjust the price relationship with the U.S.A. and also to avoid the creation of more international disequilibrium with countries which had devalued.<sup>1</sup>

The effect of devaluation is seen in the foreign trade figures of the country. The current account of 1950 showed a surplus of Rs. 70.1 crores against a deficit of Rs. 167.4 crores in 1949. In the first post-devaluation year, October 1949 to September 1950, the volume of exports to the hard currency areas was about 33.4 per cent greater than in the corresponding period immediately preceding

<sup>1</sup> United Nations, *Economic Survey of Asia and the Far East*, 1950, p. 323.

devaluation. Since prices of Indian exports also increased, the receipts from the hard currency areas from exports showed an increase of 55.6 per cent.<sup>1</sup> The impact of devaluation on foreign payments position is seen in Table 45.

TABLE 45  
EFFECT OF DEVALUATION ON FOREIGN TRADE  
(In crores of rupees)

|  | October 1949<br>to<br>September 1950 | October 1948<br>to<br>September 1949 |
|--|--------------------------------------|--------------------------------------|
| <b>A. Current Account</b>                      |                                      |                                      |
| 1. Total receipts from hard currency countries | 177.1                                | 123.6                                |
| 2. Total payments to hard currency countries   | 151.8                                | 195.7                                |
| 3. Balance                                     | + 25.2                               | — 72.1                               |
| 4. Total receipts from soft currency countries | 461.3                                | 393.6                                |
| 5. Total payments to soft currency countries   | 420.6                                | 570.3                                |
| 6. Balance                                     | + 40.7                               | —176.7                               |
| <b>B. Capital Account</b>                      |                                      |                                      |
| 7. Net assets, official, banking and private   | + 34.7                               | —245.0                               |

(Source: *Reserve Bank of India Bulletin*, November 1950, p. 780.)

Though spectacular, the effect of devaluation was short lived. The favourable trend in the balance of payments which commenced in the last quarter of 1949 after devaluation continued into the first quarter of 1950 when on current transactions there was a surplus of Rs. 30.5 crores, but in the second quarter of 1950 there was again a deficit of Rs. 19.2 crores. To a large extent devaluation had spent its force quickly, because India had no large surpluses to export, which itself was due partly to the difficulties of getting capital goods and partly to the non-devaluation decision of Pakistan.

In reality, it is difficult to make a correct estimate of the effects of devaluation in so far as some other factors were at work during

<sup>1</sup> *Reserve Bank of India Bulletin*, November 1950, p. 783.

the same time which would have produced similar results. The serious turn in the payments position with the dollar area in the first half of 1949 led to the decision at the Commonwealth Ministers' Conference to limit dollar imports to an annual rate of 75 per cent of the 1948 level and also to the suspension of dollar imports between June and September 1949 as an emergency measure. That the steps taken before September 1949 to restore balance of payments equilibrium bore some fruit is known from the steady decline in the deficits on current account in the first three-quarters of 1949.<sup>1</sup> Nor should we forget the fact that deficits in the months immediately preceding devaluation were due to some extent at least to speculative forces generated by rumours of devaluation. The favourable turn in the last quarter of 1950 was due mostly to conditions brought on by the outbreak of war in Korea. The bulk of the balance of payments surplus in 1950 was attained in the latter two quarters. The net surplus in the first and second quarters was Rs. 11.3 crores, while in the second half of the year the surplus amounted to Rs. 58.7 crores, so that of the total surplus of Rs. 70 crores for the year, the surplus in the second half constituted more than 84 per cent. This trend was due to the stockpiling demand in the West for Indian export commodities and also due to the stimulation in demand in the Middle East and Far Eastern countries arising out of increasing national incomes. On the other hand, during the last quarter of 1950, despite liberal allocation of foreign exchange and enlargement of the O.G.L., there was no appreciable change in imports mainly owing to shortages abroad. This explains the substantial surpluses in balance of payments, which continued into the first and second quarters of 1951.

(c) *Deficits, 1951-52—Slackening of War Demand*

Between the middle of 1951 and the middle of 1952, there was a progressive rise in deficits from Rs. 14.2 crores in the third quarter of 1951 to Rs. 50.8 crores in the last quarter of 1951 and to Rs. 75.4 crores in the first quarter of 1952. The second quarter of 1952 showed a moderate deficit of Rs. 5.4 crores. This adverse trend was due largely to the fall in the foreign demand for Indian materials

<sup>1</sup> The deficit came down from Rs. 102.1 crores in the first quarter of 1949 to Rs. 78.6 crores in the second quarter and to Rs. 29.5 crores in the third quarter.

for stockpiling and rearmament purposes. Both export and import prices continued to fall from the second half of 1951, the former more sharply, so that export earnings steadily declined.<sup>1</sup> At the same time, imports of essential goods increased substantially. Large imports of food under the U.S. Wheat Loan commencing from the middle of 1951, the liberalization of imports by the issue of O.G.L. XXIII in June 1951 covering a wider area and a larger number of goods and the licensing of substantial imports of raw cotton from the U.S.A. were the main factors which helped in an increase in the value of imports. This was in pursuance of government's import policy which aimed at augmenting the supply of goods required for economic development as well as for essential consumption by liberalization of imports and restriction of exports.

(d) *Surpluses since the Middle of 1952 and up to 1955-56*

It may be seen from the figures in Table 43 that, with the exception of the second quarter of 1953 and the second and third quarters of 1954, there have been a series of surpluses since the middle of 1952. The deficit in the second quarters is to be explained largely by the seasonal factor. Normally, export receipts fall to their lowest level in the second quarter, while payments for food purchases by government are concentrated in the first half of the year. On the other hand, marketing of the agricultural products is usually done in the first and last quarters of the year. The favourable balance in the two years, 1952-54, was due to fall in imports (in spite of the liberalization of imports), especially of food and raw materials for industry. Import of food in 1952 was unusually heavy, but in 1953 and 1954 increased production in the country changed the situation. Similarly, import of industrial raw materials, especially raw cotton and jute, also declined with the adoption of the policy of meeting the increased requirements of raw materials arising from industrial expansion in the country from indigenous sources of supply. In the next year, the effect of the large imports of machinery and other capital goods as a result of the rising tempo of development expenditure was offset by larger industrial output, and remarkable improvement in food and agricultural production at home, larger exports and a favourable movement in the terms

<sup>1</sup> This of course is a characteristic feature of less developed economies, the elasticity of supply of whose exports is limited.



of trade. As a result, external accounts were more or less in balance and the financial year 1954-55 showed a small surplus of Rs. 8.3 crores. In 1955-56, although the terms of trade deteriorated by about 10 per cent and imports increased more than exports, current balance of payments surplus, Rs. 16.9 crores was larger than in the previous year. This was in the main due to a substantial rise in official donations. This trend in the balance of payments is reflected in an increase in the foreign exchange reserves, which would have been more significant had there not been a small rise in the foreign exchange liabilities of the country in the same period.

Over the First Five Year Plan period, 1951-56, the current balance had a deficit only in the year 1951-52. This deficit was, however, large (Rs. 162.6 crores) and exceeded by Rs. 29.8 crores the total of the modest surpluses in the next four years. Deficit in the first year was caused by large imports of food and machinery owing to domestic food shortage and a significant rise in the rate of domestic investment under the Plan. The trend in the five years is shown in Table 46.

TABLE 46  
OVERALL BALANCE OF PAYMENTS DURING THE FIRST FIVE  
YEAR PLAN  
(In crores of rupees)

|                                 | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | Total<br>during the<br>Plan<br>period |
|---------------------------------|---------|---------|---------|---------|---------|---------------------------------------|
| Imports                         | 962.9   | 633.0   | 591.8   | 681.6   | 750.6   | 3619.9                                |
| Exports                         | 730.1   | 601.9   | 539.7   | 596.6   | 641.1   | 3109.4                                |
| Trade balance                   | -232.8  | -31.1   | -52.1   | -85.0   | -109.5  | -510.5                                |
| Invisibles                      | + 64.9  | + 80.5  | + 80.5  | + 77.5  | + 84.4  | +387.8                                |
| Official donations              | + 5.3   | + 10.8  | + 19.0  | + 15.8  | + 42.0  | + 92.9                                |
| Current balance                 | -162.6  | + 60.2  | + 47.4  | + 8.3   | + 16.9  | - 29.8                                |
| Errors and omissions            | - 45.0  | - 25.7  | + 2.3   | - 12.9  | - 5.3   | - 86.6                                |
| Official loans                  | + 59.6  | + 35.1  | + 1.6   | + 0.6   | + 6.5   | +103.4                                |
| Other capital trans-<br>actions | - 20.6  | - 51.1  | - 20.3  | - 13.2  | - 3.1   | -108.3                                |
| Change in reserves:             |         |         |         |         |         |                                       |
| Increase (+)                    | -168.6  | + 18.5  | + 31.0  | - 17.2  | + 15.0  | -121.3                                |
| Decrease (-)                    |         |         |         |         |         |                                       |

(Source: *Reports on Currency and Finance*, 1955-56 and 1956-57, Reserve Bank of India.)

Excluding official donations, the current deficit during the First Plan period was of the order of Rs. 123 crores—an amount much less than what was anticipated by the Planning Commission (Rs. 667 to Rs. 727 crores). Against this has to be set official donations (Rs. 93 crores) and official loans (Rs. 103 crores) which together more or less offset the deficit of Rs. 123 crores plus the unidentifiable payments merged under “Errors and Omissions” of Rs. 86.6 crores. The decline in net reserves of Rs. 121 crores over the five years was therefore on account of other capital transactions outside the needs of the Five Year Plan, which led to a capital outflow of Rs. 108 crores.

An overall picture of the financial aspect of the balance of payments trends in India in these years can be seen in the movement of foreign exchange reserves which consist of Reserve Bank of India assets, government balances and authorized dealers’ holdings. This is shown in Table 47.

TABLE 47

## MOVEMENT IN FOREIGN EXCHANGE RESERVES, 1951-56

(In crores of rupees)

| <i>As at the end of March</i> | <i>Reserves</i> | <i>Foreign exchange liabilities</i> | <i>Net reserves</i> |
|-------------------------------|-----------------|-------------------------------------|---------------------|
| 1951                          | 963.9           | 129.0                               | 834.9               |
| 1952                          | 795.3           | 140.7                               | 654.6               |
| 1953                          | 813.8           | 102.8                               | 711.0               |
| 1954                          | 844.8           | 87.1                                | 757.7               |
| 1955                          | 827.6           | 75.8                                | 751.8               |
| 1956                          | 842.6           | 80.9                                | 761.7               |

(Source: *Reserve Bank of India Bulletin*, June 1956, p. 617.)

In one year (1952) the foreign assets held by the monetary authorities in India fell by about Rs. 180 crores. In the other years excepting a small decline of Rs. 6 crores in 1955, there have been

increases in the net reserves, thanks to the improvement in the country's balance of payments position. The total net decrease (Rs. 121 crores) is less than half of what was anticipated by the Planning Commission. This discrepancy between the estimated and actual draft on foreign reserves is due to substantial increase in domestic food output, the failure to start some of the proposed construction work during the Plan period and the fact that the actual investment under the First Plan came to be less than was visualized by the Commission.

(e) *Adverse Trends in the Second Plan Period*

With the commencement of the Second Plan period the trend in India's external payments has taken an adverse turn. The pressure on the country's foreign balances continued to be heavy up to the close of the third year of the Plan, but since then has eased a little. Against the estimated average annual value of Rs. 868 crores, imports were running well over Rs. 1,000 crores in the first three years touching the peak level of Rs. 1,234 crores in 1957-58. The increase in imports was entirely on government account; private imports in these years actually showed a steady and marked decline. Imports on government account increased from Rs. 287.6 crores in 1956-57 to Rs. 574.4 crores in the next year and amounted to Rs. 524.8 crores in 1958-59, while private imports declined from Rs. 811.9 crores in 1956-57 to Rs. 696.2 crores in 1957-58 and further to Rs. 504.8 crores in 1958-59. Against the steady rise in imports, exports receded from Rs. 635.2 crores in 1956-57 to Rs. 594.1 crores in the next year and to Rs. 575.9 crores in 1958-59. Deficit in trade balance was over Rs. 450 crores in the first and third year of the Plan but reached nearly Rs. 640 crores in the second year. Allowing for "official donations" and other "invisibles" the current account deficit was Rs. 312.3 crores in 1956-57, Rs. 501.4 crores in 1957-58 and Rs. 327.6 crores in 1958-59. The major factors responsible for this unexpected turn in foreign trade were the sharp rise in the foreign exchange cost of some of the projects in the Plan, larger food imports and defence materials and the import of raw materials and components needed for industries which had been started in earlier years. The large deficits on current account necessitated heavy drawings on the foreign reserves of the country amounting to Rs. 221.3 crores, Rs. 259.9 crores and Rs. 42.3 crores respectively

in the first three years of the Plan. The availability of foreign loans (including drawings from the International Monetary Fund) in a substantial measure in 1958-59<sup>1</sup> accounts for the marked decline in the draft on foreign reserves in that year. Over the three years foreign reserves declined by Rs. 296 crores (from Rs. 683.5 crores at the end of 1956 to Rs. 387.5 crores at the end of 1959). Towards the close of 1958, it reached the low of Rs. 343.9 crores.

The adoption of a stringent import policy even as early as 1957, combined with an earnest attempt to step up exports improved the position to a considerable extent. Government imports sharply declined from Rs. 525 crores in 1958-59 to Rs. 416 crores in 1959-60,<sup>2</sup> while private imports have remained slightly above Rs. 500 crores. On the other hand, in these two years exports improved from Rs. 575.9 crores to Rs. 623.3 crores with the result that current account deficit was brought down from Rs. 328 crores to Rs. 181 crores. Consequently foreign reserves were drawn to the extent of only Rs. 16.1 crores in 1959-60 against Rs. 260 crores in 1957-58. Foreign Exchange reserves of the country improved from Rs. 344 crores at the end of 1958 to Rs. 388 crores at the end of 1959. There has been, however, a disquieting downward trend since then. Towards the close of June 1960 foreign reserves had receded to the low level of Rs. 323 crores.

Thus over the four years 1956-57 to 1959-60 imports and exports totalled Rs. 4,286 crores and Rs. 2,428 crores respectively leaving a trade balance gap of Rs. 1858 crores. The current account deficit aggregated to Rs. 1,322 crores. This deficit has been covered to the extent of Rs. 600 crores or 45 per cent by foreign loans and Rs. 540 crores or 40 per cent by the drawing down of foreign reserves. Other net receipts under capital account covered the balance of 15 per cent.

#### *Balance of Payments and Prices*

Since a surplus on external current account represents an excess of foreign demand, it should normally exert an upward pull on domes-

<sup>1</sup> Rs. 218.6 crores in 1958-59 as against Rs. 85.4 crores and Rs. 134.6 crores in the first two years.

<sup>2</sup> Figures for 1959-60 "preliminary"—*Reserve Bank of India Bulletin*, July 1960, p. 926.



tic price level. Conversely an external deficit should have a deflationary effect on the economy. In reality, however, the relationship between balance of payment trends and price level in the country is not so direct and intimate. In other words surplus in current account need not necessarily involve or bring about a rise in the price level any more than a deficit bring about a fall in the price level. This is because of the offsetting factors that may be operating in the economy. If any increase in domestic spendings is balanced by increased production and incomes, but at the same time the demand for the country's exports increases, the effect would be both a surplus on current account and a tendency for prices to rise. This rise in price is facilitated by an increase in money supply made possible by an increase in foreign reserves. Thus, when government budgets are balanced and bank credit is constant, but the country has a surplus on external current account any increase in money supply and price level can be attributed to the balance of payments trends. It, therefore, follows that the pressure of external excess demand can be counterbalanced by domestic budgetary deficits and contraction of bank credit. Conversely, any inflationary pressure generated by domestic factors like rise in the level of investment activity, deficit spending and expansion of bank credit can be held in check or counteracted by external deficit. All this would mean that a direct cause and effect relationship cannot be established between changes in external payments situation and changes in domestic price level at any period of time. It is possible only to assess the relative strength of the opposing forces and indicate broadly the extent to which any factor or factors have predominated in determining a given price trend.

In the early post-war years particularly since the beginning of 1947 and up to 1949 balance of payments consistently showed deficits. At the same time money supply increased and the general price level steadily went up. This would only mean that fall in external demand was more than offset by the pressure of domestic demand in relation to supply. Powerful forces were at work in the country which pushed up price level and thereby affected the external trade of the country. Fall in production, relaxation of controls, the release of the pressure of pent up consumers' demand, all these sent prices soaring. Throughout this period, price level in India went up at a faster rate and remained consistently at a much higher level than in countries with which she had intimate trade relations.

This is shown in the following price indices. On the whole then, the deficit in the balance of payments in this period was mostly the

| <i>Year</i> | <i>U.S.A.</i> | <i>U.K.</i> | <i>Australia</i> | <i>India*</i> |
|-------------|---------------|-------------|------------------|---------------|
| 1945        | 123           | 155         | 140              | 245           |
| 1946        | 140           | 161         | 141              | 275           |
| 1947        | 176           | 176         | 150              | 308           |
| 1948        | 191           | 202         | 170              | 376           |
| 1949        | 180           | 212         | 189              | 385           |

\* Figures relate to financial years beginning 1945-46.

For U.S.A., U.K., and Australia base 1937 = 100.

For India base 19th August 1939 = 100; up to 1946-47 sensitive series and for the last three years general purpose series.

effect of the internal price structure; yet, to the extent there were consistent deficits, it may be assumed that the large adverse balance of payments had some moderating influence on the inflationary pressure brought into being in the national economy by continuous deficit financing throughout the war and subsequently.

Devaluation in 1949 should have augmented the inflationary forces in the country in so far as it raised directly the price of import goods from dollar areas, gave an impetus to exports from the country and thereby restricted the supply available for home consumption. In the twelve month period October 1949 to September 1950, the foreign assets of the Reserve Bank of India increased by nearly Rs. 30 crores and money supply in the country went up by Rs. 23 crores against a fall in the foreign assets of Rs. 242 crores and contraction in money supply of Rs. 120.5 crores in the preceding twelve months. The inflationary effect of the surplus in the balance of payments and expansion of money supply was modified by the fact that government balances with the Reserve Bank actually increased to some extent (Rs. 18 crores) during this period and there was a contraction in the Reserve Bank's credit to government as well as in the scheduled bank's credit.<sup>1</sup> Furthermore, the timely measures adopted by government in anticipation of further inflation also helped in preventing price level from rising in the wake of devaluation to a greater extent than it actually did. Thus, while the effect

<sup>1</sup> P. S. Narayana Prasad, "Devaluation and After", *Reserve Bank of India Bulletin*, November 1950, p. 786.

of devaluation on balance of payments was quite favourable; its effect on the price level in the country was less unfavourable than it was feared.

While the rise in prices up to 1950 has to be attributed mostly to domestic factors and the external deficits were due to the pressure of excess demand at home, the position altered completely in 1950-51. The outbreak of war in Korea and the military preparations in some of the leading industrial countries of the world caused a boom in the demand for our export products. In 1950-51 exports increased to Rs. 647 crores from Rs. 514 crores in the previous year and imports from Rs. 604 crores to Rs. 650 crores. The rise in prices hides the change in the quantum of trade. Thus in terms of volume, imports actually declined because of the intensification of import restrictions. The index of volume of imports fell from 135 in 1948-49 to 127 and 112 in the succeeding two years. On the other hand both the value and volume index of exports rose sharply, the first from 91 to 111 in 1950-51 and to 153 in 1951-52 and the second from 112 in 1949-50 to 117 in the next year (Base 1952-53=100). As a result, the net terms of trade<sup>1</sup> improved from 118 to 134. The improvement in the balance of trade is reflected in an increase in the foreign exchange reserves of the country from Rs. 894 crores in 1949-50 to Rs. 913 crores in 1950-51. As against this external pressure domestic conditions were not favourable to a rise in price. Both agricultural and industrial production improved. The general index of industrial production rose from 105 in 1950 to 117 in 1951 (Base 1946=100). Although there was a setback in food production this was more than offset by the marked rise in the production of industrial raw materials and other agricultural commodities. In the two years scheduled bank credit expanded by only 4 per cent from Rs. 442 to Rs. 459 crores while the Union Government's overall budget deficit of Rs. 44 crores in 1949-50 was converted into a surplus of Rs. 12 crores in the next year. Hence the increase in money supply in these two years from Rs. 1865 crores to Rs. 1966 crores, and in the price level by 6 per cent—from 385.4 to 409.7 points (Base, year ended August 1939=100)—has to be attributed largely to increase in external demand. In the same manner, the recession following the easing of the demand for stock-piling in the West had an adverse effect on foreign trade and through it influenced the price structure in the country.

<sup>1</sup> Ratio of export price index to import price index.

Excepting the first year of the First Plan period when recessionary conditions affected external trade and caused a current account deficit of over Rs. 160 crores external pressure on the demand side continued to be high throughout the First Plan years. Over the period 1952-53 to 1955-56 current account surplus totalled Rs. 133.5 crores and the foreign exchange reserves increased by about Rs. 100 crores. The favourable trend in the balance of trade of India since the middle of 1952 was in one sense a sharing of the world-wide trend in which the balance of payments position of the non-dollar world on the whole improved. This was the effect of the favourable turn to production which the Korean boom gave. The result was a marked recovery in the volume of world trade and a considerable easing in the dollar problem of the world. So far as India was concerned, the terms of trade, which rapidly deteriorated since 1951, moved to the advantage of the country in the first half of 1954. Thus the indices of the terms of trade (with base 1948=100) went up from 92 in 1952 to 97 in 1953 and to 101 in 1954, but came down to 99 in 1955.<sup>1</sup> The improvement in the foreign trade position was due to a large extent to this favourable turn in the terms of trade. Another factor responsible for this improvement in 1953-55 was the decline in the imports of food and raw materials. With a steady decline in price indices of imports from 136 to 118 and 111 in 1952, 1953 and the first half of 1954, quantity indices also declined from 88 to 64 and 60. This lack of response of imports to price variations should be ascribed mostly to the improvement in the production of food and some raw materials in 1954-55 which caused a sharp decline in the import of these commodities. The effect of improved food production in the country on the import of this item, which constituted a good proportion of the total visible imports since the close of the war, can be known from the fact that the indices of food imports with base 1948-49=100 stood at 106 in 1952 and came down to 56 in 1953 and 15 in the first half of 1954. In other words, food imports declined between 1952 and 1954 by more than 85 per cent. This explains largely the relative stability in price level in spite of the step up in investment and development expenditure at home and the continuance of a high level of external demand over the First Plan period.

The persistent current account deficit in the Second Plan period was largely due to the excess demand generated at home by increased

<sup>1</sup> *U.N. Year Book of International Trade.*



investment outlay. The large budgetary deficits and the considerable increase in bank credit constitute a rough indicator of the extent to which excess demand has increased in the economy. The rise in production at home was not sufficient enough to absorb the increase in demand. Output of food grains, industrial raw materials and manufactured goods showed much fluctuations in these years although the net gain between 1956 and 1959 was 11 per cent in the case of food grains and 13 per cent and 12 per cent respectively in the case of industrial raw materials and manufactures. The rise in money incomes resulting from large deficit financing and acceleration in economic activity in both the private and public sectors of the economy have called for a considerably larger increase in imports than was anticipated. The rise in imports has been particularly marked in the case of food, iron and steel and capital goods. The annual average of imports has well exceeded Rs. 1,000 crores as against the corresponding amount of Rs. 725 crores in the First Plan years. The large demand for foreign goods and materials represents, therefore, a spill over of excess spendings in the country into imports.

Inflationary pressures in the economy can be held in check to the extent supply of goods available in the country is increased by means of imports. The trade deficit indicates the extent to which supply has been augmented in this manner. Increase in the supply of resources from outside is made possible by means of external loans which are converted into real resources and also by drawing on past savings in the form of foreign reserves. It is thus clear that so long as the amount of foreign reserves is sufficiently high, it can have a moderating effect on inflationary pressures generated by deficit spending. And a decline in external balances means that we cannot rely upon this extenuating factor. It is the rapid decline in our foreign exchange reserves in recent years that has drawn attention to the urgent need to keep down to the minimum possible the scale of deficit financing in the last two years of the Second Plan period. The same factor has weighed with the Planning Authorities in fixing the limits of this method of financing at a low level in the Third Plan.

## CHAPTER IX

### PRICES AND PRODUCTION

THE GENERAL price level in a country in any period of time obviously depends on the demand for goods and services as seen in the volume of money offered and the supply of these goods and services. In the earlier chapters we have examined some of the important factors which have affected money supply in India in recent years, such as spendings by the government and the movements in the country's balance of payments. It is a simple truism that increased money supply showing itself in increased spendings would not result in any rise in prices if this is matched by a proportionate increase in the volume of goods and services also. Our analysis of the inflationary price trends in India during the war and post-war period will not be complete unless the supply side is also taken into account. In this chapter we shall briefly analyse the production trends in India during and after the war and examine what part the supply position in the country played in the determination of the price level.

Changes in the level of production are brought about by changes in demand. Thus, when a country is engaged in war or when a national programme of planned economic development has been started, greater demand is created for factors of production and productive resources. During war resources are used for the production of goods and services which are not required and are not useful for private consumers. Thus, while income is generated by the increased spending activity of the government and as a result the purchasing power available for private consumers goes up, there is no increase in the supply of consumption goods, or there is even a decrease in the same, so that prices of such goods tend to rise. This leads to higher prices of the factors of production and higher wages and causes an inflationary price trend. Even when increased government spending is for developmental purposes, a rise in prices is likely to develop in so far as the higher level of investment on capital equipment, which is necessary to ensure increased production and larger supply of consumption goods at a later stage, would not in the short period tangibly affect the scale of output of consumption goods.

In theory, so long as a part of a country's resources remains idle

or unemployed, increased spending for development purposes will only help to draw into use unutilized resources and increase national output without affecting seriously the price structure. On the other hand, if the increase in demand takes place when there is already full employment, it would show itself mostly in a rise in prices. This is so because in order to increase output factors will have to be diverted from their existing employment by the offer of higher prices. Thus prices tend to rise via higher costs of production. If, however, a state of overfull employment develops in which the demand for the services of the factors is in excess of their supply, the tendency for cost of production and prices to go up will be greater for a variety of reasons. In such a situation, workmen have a tendency to slacken and to resort to strikes for flimsy reasons, the quantity and quality of output deteriorate, while business men, confident of expanding demand in the market, develop what is called a "cost plus profit" mentality which is reflected in their preparedness to pay higher wages and add that on to the prices of the finished product. It is also possible to conceive of an intermediary situation in which an increase in demand when there is moderate unemployment will cause an increase in output and also a moderate rise in prices.<sup>1</sup>

The existence of idle resources in the context of increased spending or demand is, however, not a guarantee against changes in price level in the upward direction. It is obvious that it is not increased production so much as the supply that is actually available for the community's consumption against the demand for it that determines prices. Thus in a war period, although idle resources are drawn into use and production is increased, prices rise because of the restriction in the supply of goods and services available for general consumption. On the other hand, in peace time economic development, rise in production attended with rise in purchasing power does not result in any great price rise. This can be illustrated by recent production and price trends in India.

#### *The General Pattern of Production Trends since 1939*

It is possible to distinguish three important phases in the general production trends in India since 1939. Soon after the outbreak of war, there was a feverish attempt to mobilize the resources of the

<sup>1</sup> Theodore Morgan, *Income and Employment* (1947), pp. 104-5.

country for war purposes and to increase production. In the first two years of war, there was not any notable change in the level of national output, but the production process gained momentum quickly and in 1943-44 the peak level in agricultural and industrial production was reached. The years 1940 to 1944 thus constitute the first phase. Since 1944 there was a steady decline in output owing to a series of political and social factors, and the economy remained at a low level with some minor fluctuations between 1947 and 1951. The third phase, marked by increased business activity and higher levels of production and employment synchronizing with the era of planned economic development of the country, commenced in 1951. Indices of business activity and industrial and agricultural production given in Tables 48 and 49 and Chart VI based on these figures bring into relief these three phases.

It may be seen from Table 48 that during war period industrial production registered a steady rise up to 1944 when it touched the peak level of 115.7 points. On the other hand, agricultural produc-

TABLE 48  
PRODUCTION TRENDS IN INDIA, 1939-50

| Year    | Index Nos. of<br>agriculture<br>production* | Index Nos. of<br>industrial<br>production† | Index Nos. of<br>business<br>activity‡ |
|---------|---|--|--|
| 1939-40 | 99  | —  | 105.2                                  |
| 1940-41 | 98  | 108.1                                      | 105.7                                  |
| 1941-42 | 95  | 114.3                                      | 113.5                                  |
| 1942-43 | 102   | 106.9                                      | 108.0                                  |
| 1943-44 | 106   | 112.2                                      | 111.5                                  |
| 1944-45 | 101   | 115.7                                      | 117.0                                  |
| 1945-46 | 94  | 112.5                                      | 119.7                                  |
| 1946-47 | 96  | 102.9                                      | 111.9                                  |
| 1947-48 | 100   | 99.1                                       | 104.0                                  |
| 1948-49 | 95  | 112.3                                      | 107.3                                  |
| 1949-50 | 100   | 108.4                                      | 104.3                                  |

(Sources: \* *Eastern Economist*, Annual Numbers and Quarterly Records and Statistics. Base: average 1936-37 to 1938-39 = 100.

† *Indian Labour Gazette*, November 1955. Base: 1939 = 100. Figures relate to Calendar years beginning 1940 — 108.1.

‡ *Eastern Economist*. Base: Year ended August 1939 = 100.)



TABLE 49-

## PRODUCTION TRENDS IN INDIA, 1950-51 TO 1960-61

| Year    | Index Nos. of<br>agricultural<br>production* | Index Nos. of<br>industrial<br>production† |
|---------|--|--|
| 1950-51 | 95.6   | —  |
| 1951-52 | 97.5   | 100  |
| 1952-53 | 102.0  | 103.6                                      |
| 1953-54 | 113.4  | 105.6                                      |
| 1954-55 | 117.0  | 112.9                                      |
| 1955-56 | 116.9  | 122.4                                      |
| 1956-57 | 123.6  | 132.6                                      |
| 1957-58 | 114.6  | 137.3                                      |
| 1958-59 | 131.0  | 139.7                                      |
| 1959-60 | N.A.   | 151.1                                      |
| 1960-61 | 135.0‡                                       | 169.6§                                     |

\* Base: Crop year ending June 1950 = 100.

† Base: 1951 = 100. Figures relate to calendar years. Thus 1952—103.6.

‡ Expected. *Third Five Year Plan—a Draft Outline* (Government of India Planning Commission), p. 17.

§ January 1960.

(Source: *Economic Survey*, Government of India, 1958-59 and 1959-60. *Reserve Bank of India Bulletin*, July 1960.)

tion showed a downtrend in the first two years of the war, but after that recovered and went up to the highest point of 106 in 1943-44. Since that year, both agricultural and industrial production rapidly declined. The level of business activity reached the highest point of 119.7 in 1945-46, i.e. two years later than agricultural and industrial production, but from that year onward it shared the fate of general production in the downward direction.

This general pattern is visible in the national product figures also. It must be noted that figures relating to output in the different years under review do not give a correct idea of the actual increase in real output or the proportion of the total output available for consumption. This obviously is because of the distortion caused by price changes. Measurement of the increase in real output as between peace time and war period is rendered difficult both by the changes in the composition of the output and by the differences in the quality of products belonging to the same categories. In order to estimate the actual increase in output, it is necessary to deflate the

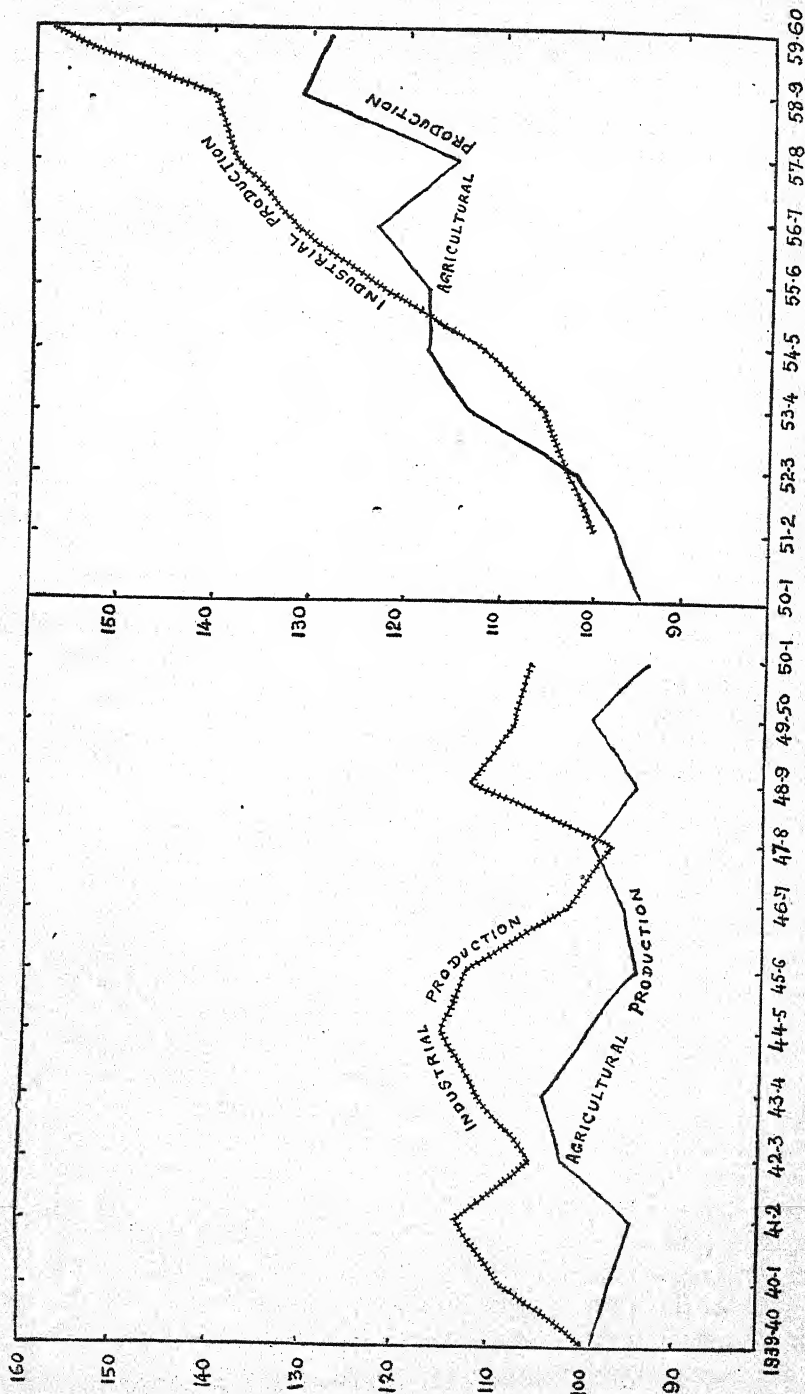


Chart VI: Production Trends since 1939.

value of current output by an appropriate price index. One of the methods usually adopted is to deflate national product by the cost of living index. To the extent that the cost of living figures underestimate the rise in prices, the result will be an over-estimation of the value of the product. Nevertheless this can be taken as a fairly satisfactory method of measuring changes in real output. The figures in column 3 of Table 50 are calculated on this principle. Official national income figures are available for the years 1948-49 to 1958-59. These are given in Table 51. For the earlier years estimates made by the *Eastern Economist* are used. The figures in the two tables are therefore not comparable.

National product in current rupees increased by 80 per cent between 1939-40 and 1942-43 and in real terms by 14 per cent. The real output in 1947-48 was 27 per cent less than what it was in 1942-43. Between 1948-49 and 1958-59, real income increased by 34 per cent. The set of figures in the last columns in Tables 50 and 51 illustrates the broad changes in the production trends during the war period and in the subsequent years.

TABLE 50

NATIONAL PRODUCT IN THE INDIAN UNION IN CURRENT AND  
1939 RUPEES, 1939-48

(In crores of rupees)

| Year    | National product<br>in current<br>rupees | National product<br>in 1939<br>rupees |
|---------|--|---------------------------------------|
| 1939-40 | 2723                                     | 2593                                  |
| 1940-41 | 2885                                     | 2646                                  |
| 1941-42 | 2959                                     | 2425                                  |
| 1942-43 | 4887                                     | 2949                                  |
| 1943-44 | 6294                                     | 2785                                  |
| 1944-45 | 6317                                     | 2807                                  |
| 1945-46 | 6308                                     | 2767                                  |
| 1946-47 | 6518                                     | 2587                                  |
| 1947-48 | 5762                                     | 2150                                  |

(Compiled from the estimates of Indian national income made by the *Eastern Economist* by adding 30 per cent to the figures of national income for India excluding the former Indian States. For deflating national income, the Bombay cost of living indices [Base: Week ended 19th August 1939 = 100] have been used.)

TABLE 51

## TRENDS IN NATIONAL INCOME SINCE 1948-49

(In crores of rupees)

| <i>Year</i> | <i>Net output at<br/>current prices</i> | <i>Net output at<br/>1948-49 prices</i> |
|-------------|---|---|
| 1948-49     | 8650                                    | 8650                                    |
| 1949-50     | 9010                                    | 8820                                    |
| 1950-51     | 9530                                    | 8850                                    |
| 1951-52     | 9970                                    | 9100                                    |
| 1952-53     | 9820                                    | 9460                                    |
| 1953-54     | 10480                                   | 10030                                   |
| 1954-55     | 9610                                    | 10280                                   |
| 1955-56     | 9980                                    | 10480                                   |
| 1956-57     | 11310                                   | 11000                                   |
| 1957-58     | 11360                                   | 10830                                   |
| 1958-59     | —                                       | 11570*                                  |
| 1959-60     | —                                       | 11628*                                  |

\* Based on "Quick Estimates" made by the Central Statistical Organization.  
(Source: *Reports on Currency and Finance*, Reserve Bank of India.)

It is noteworthy that the highest rate of increase in general price level was during the years 1940 to 1943 when the rate of increase in production was also at the maximum. Between 1943 and 1951, while production declined and remained at a low level, the general price level continued to rise and reached the highest point in the latter year. Since the recession of 1952, the general price level remained fairly stable for some time, then declined and since 1955 has been steadily rising, while both agricultural and industrial production showed on the whole a steady improvement. The synchronization of a high rate of increase in output with a rapid rise in prices during the war period was due to the special circumstances of war, which would be explained presently. The rise in prices since the close of the war and up to 1951 and the fluctuations since then were to a substantial extent influenced by the trends in production and domestic supply conditions in the same periods. The extent to which the three broad phases of production in the war and post-war periods reacted on the general price level in the country may now be briefly examined.



*Prices and Production in the War Period*

In the first five years of war, agricultural production in India increased by 6 per cent and industrial production went up by 27 per cent. The details of this increase are shown in Tables 52 and 53. Compared with the achievements in advanced countries in the same period, the rise in national output in India was quite meagre. Between 1939 and 1944 physical output in Canada increased by 80 per cent and in the U.S.A. it more than doubled. However, if we compare the production trends in India in the pre-war and post-war periods with that in the war period, the expansion in the war years appears quite significant.

The resources for war are found usually out of increased production, restricted consumption and out of capital, i.e. by the using up of current capital without replacing worn-out equipment. If there is excess capacity in the national economy whether in the form of unutilized land or unemployed labour or idle capital equipment, it is drawn into productive use and fully utilized. Besides, during war new industries are started and efficient and improved methods of production are adopted. Of special significance to economies where conditions of monopolistic competition prevail is the fact that when there is a phenomenal increase in demand for goods and services and the market for them is assured, marketing costs can be cut down considerably and the resources normally used for pushing up the sale of commodities, as for example, by means of advertisement, can be utilized for more productive purposes. But, on the other hand, there are certain factors which hamper increased production during war time. Long hours of work cause considerable strain on the labourer and reduce his efficiency. The offer of high wages ceases to be an incentive in the context of a rapidly rising price level. Many plants and machines are over-strained and made to produce beyond the optimum. The effect of this is usually seen soon after the close of the war when there is a widespread breakdown of the machines which cannot be replaced immediately and this threatens to bring the productive mechanism to a virtual standstill.

Further, when prices, profits and taxes are all high and continue to go higher still, businessmen lose the incentives of management and tend to be careless and inefficient. Lastly, if inflation develops, as it usually happens as a result of increased demand and higher levels of

TABLE 52  
AGRICULTURAL PRODUCTION IN INDIA, 1939-44

| <i>Crop</i>                        | <i>Average for<br/>1936-37 to<br/>1938-39</i> | <i>Average for<br/>1939-40 to<br/>1942-43</i> | <i>1943-44</i> |
|------------------------------------|---|---|----------------|
| Principal foodgrains (000 tons)    | 55268   | 54399   | 60455          |
| Area under foodgrains (000 acres)  | 193252  | 193978  | 206690         |
| Cotton (000 bales of 400 lb. each) | 5653  | 5478  | 5259           |
| Cotton area (000 acres)            | 24665   | 22061   | 21086          |
| Sugarcane (000 tons)               | 5089  | 4975  | 5848           |
| Sugarcane area (000 acres)         | 3813  | 3838  | 4234           |
| Tea (000 lb.)                      | 425798  | 492858  | 573774         |
| Tea area (000 acres)               | 834   | 835   | 838            |
| Jute (000 bales of 400 lb. each)   | 8362  | 9354  | 6990           |
| Jute area (000 acres)              | 2980  | 3580  | 2640           |
| Tobacco (000 tons)                 | 489   | 466   | 376            |
| Tobacco area (000 acres)           | 1254  | 1270  | 1019           |

(Source: *Estimates of Area and Yield of Principal Crops, 1936-46*. Directorate of Economics and Statistics, Ministry of Agriculture, Government of India.)

TABLE 53  
INDUSTRIAL PRODUCTION IN INDIA, 1939-44

| <i>Year</i> | <i>Jute manu-<br/>factures<br/>(000<br/>tons)</i> | <i>Cotton<br/>piece-<br/>goods<br/>(million<br/>yards)</i> | <i>Sugar<br/>(000<br/>cwt.)</i> | <i>Paper<br/>(000<br/>tons)</i> | <i>Pig iron<br/>(000<br/>tons)</i> | <i>Finished<br/>steel<br/>(000<br/>tons)</i> |
|-------------|---|--|---------------------------------|---------------------------------|------------------------------------|--|
| 1939        | 1179  | 4114   | 13910                           | 1312                            | 1757                               | 1026   |
| 1940        | 1234  | 4812   | 23649                           | 1677                            | 1994                               | 1187   |
| 1941        | 1194  | 4530   | 24201                           | 1854                            | 2010                               | 1360   |
| 1942        | 1082  | 4025   | 17703                           | 1809                            | 1830                               | 1272   |
| 1943        | 966   | 4751   | 21540                           | 1791                            | 1748                               | 1315   |
| 1944        | 995   | 4857   | 21065                           | 1524                            | 1419                               | 1299   |

(Source: *Survey of Business Conditions in India*.)

economic activity, the uncertainty of future prices discourages enterprise but promotes speculative piling up of inventories. It should, however, be observed that most of these drags on production

take time to become operative, so that in the first few years of war, when the whole productive mechanism is geared to a higher level of activity, there is a steady rise in the national output.

To some extent expansion of industrial output during the war years in India was achieved by the starting of new industries and by additions of extra plants to the existing industries. Among the new industries started during this period were aluminium, machine tools, bichromates, ferro alloys and aircraft; in the case of chemical industries, glass manufacture, woodware particularly plywood, tanneries, woollen and silk manufacture and bicycles, certain new factories were added to existing ones. In silk manufacture, iron and steel and leather industries, output was increased by means of additions of extra plants. These measures, however, were responsible for only a small proportion of the total increase in production. This was so because industrial expansion involving the establishment of new factories and the starting of new industries had become very difficult during war when machines and other capital equipment could not be procured from foreign countries. The value of machinery of all kinds imported into India came down from Rs. 19.7 crores in the pre-war year 1938-39 to as low as Rs. 10.5 crores in 1942-43. While in the three years, 1944-45 to 1946-47, the number of joint-stock companies increased from 13,689 at the end of 1943-44 to 21,853 or by 60 per cent and their paid-up capital from Rs. 353.74 crores to Rs. 479.47 crores or by 36 per cent, there was comparatively only a small increase of 20 per cent in the number of companies and 16 per cent in their paid-up capital in the preceding five years, 1939-40 to 1943-44.<sup>1</sup>

In the presence of serious difficulties in expanding existing industries or starting new ones, it was inevitable that increase in industrial output could be attained only by the fuller utilization, and sometimes over-utilization, of existing capital equipment. The rapid increase in the average number of workers in factories is one of the broad indicators of the extent to which this means was resorted to. The increasing absorption of idle labour brought about full employment in a restricted sense of the term, namely, employment of nearly the maximum amount of labour force possible in relation to the volume of capital equipment.

<sup>1</sup> Joint stock companies in British India and in the Indian States of Hyderabad, Mysore, Baroda, Gwalior, Indore, Travancore and Cochin. (Department of Commercial Intelligence and Statistics, Government of India.)

TABLE 54

AVERAGE DAILY NUMBER OF WORKERS EMPLOYED IN  
FACTORIES IN BRITISH INDIA, 1939 AND 1944

| <i>Industries</i>       | <i>No. of workers</i> |         |
|-------------------------|-----------------------|---------|
|                         | 1939                  | 1944    |
| Textiles                | 819404                | 996396  |
| Food, drink and tobacco | 247630                | 294809  |
| Gins and presses        | 163226                | 143417  |
| Engineering             | 159761                | 300395  |
| Paper and printing      | 56932                 | 67502   |
| Chemical dyes, etc.     | 57966                 | 90749   |
| Railway workshops       | 55784                 | 121684  |
| Minerals and metals     | 55123                 | 91126   |
| Wood, stone and glass   | 53084                 | 100409  |
| Ordnance factories      | 30709                 | 158327  |
| Skins and hides         | 12906                 | 34624   |
| Clothing                | 2157                  | 24938   |
| Miscellaneous           | 36455                 | 98377   |
| <i>Total</i>            | 1751137               | 2522753 |

(Source: *Indian Labour Gazette*.)

Between 1939 and 1944 there was a spectacular increase in employment in the engineering and chemical industries, railways and ordnance factories. Total employment in all the factories increased by 44 per cent. Assuming the working force in the country to be about 40 per cent<sup>1</sup> of the total population, the proportion of factory labourers to working force increased from 1.75 per cent in 1939 to 2.4 per cent in 1945. There should have been a proportionate increase in employment in cottage industries, in mining and also in the clerical jobs. Fuller utilization of existing capital is also indicated by the extra shifts introduced in many industries and increase in the number of working hours. In 1944, in the cotton textile industry 66 mills with 85,016 workers in Bombay and 65 mills with

<sup>1</sup> According to the Census of 1941 it was 38.6 per cent and in 1951 it was 39.6 per cent. See *Final Report of the National Income Committee* (1954), Ministry of Finance, Government of India, p. 10.



47,629 workers in Ahmedabad worked night shifts.<sup>1</sup> In the jute industry, the number of working hours was increased from 45 to 54 and later to 60 a week. While before the war the industry was working with 25 per cent of the looms sealed, towards the last quarter of 1942 all the looms were unsealed. Besides, during this period, while the number of labourers in factories increased by nearly 50 per cent and although the number of disputes resulting in stoppage of work increased, the number of working days lost was on the average much less than in the pre-war or post-war years.

Agriculture benefited little in spite of increasing demand both at home and abroad, rising prices and widening profit margin of the producers. Soon after the outbreak of war, there was a speculative rise in agricultural prices, especially the prices of commercial export crops like jute, cotton and copra. This resulted in temporary increase in the acreage under groundnut, jute, castor, sugarcane, sesamum, cotton, rape and mustard. But the tide soon turned when the reverses of the Allies in the European theatres and the extension of the war to the East resulted in a serious loss of markets. Japan's entry into war meant a loss of the market for one and a half million bales of our short staple cotton. Simultaneously, increasing shipping difficulties produced a considerable fall in demand in the U.S.A. for our jute products and oilseeds. As a result, there was a heavy drop in the prices of commercial crops. At the same time, the loss of Burma cut off from India's normal sources of supplies 14 lakh tons of rice per year. This combined with adverse seasons, especially in Bengal, created scarcity conditions in the matter of foodgrains, the price of which rapidly spurted up. A vigorous campaign was started by the government for effecting a shift of production from commercial to food crops. The effect is seen in the variation in the acreage under commercial and food crops during this period (Table 52). Apart from this, the results on the side of total production were very meagre. It is clear that a permanent increase in agricultural output cannot be secured unless there is long-term investment for productive purposes in the form of irrigation works and land improvement. This was not possible during the war period.

Between 1941 and 1944, along with increase in agricultural and industrial production there was a rapid rise in the general price level also. The explanation of this phenomenon lies in the fact

<sup>1</sup> *Indian Labour Gazette*, January 1944.

that while as a result of increase in employment and rise in money wages the total purchasing power of the people expanded, the supply of goods available for civilian consumption was considerably restricted. The proportion of wage bill to national income was 3.5 per cent in 1944-45 as against 2.6 per cent in 1939-40. Between these two points of time, while national income increased by about 120 per cent, total wage bill in organized industries went up by nearly 200 per cent. While the large increase in demand of the government considerably added to the money earnings and the purchasing power available in the country, the diversion of a large proportion of the output for war purposes caused a widening gap between the volume of purchasing power and the supply of goods and services available for consumption by the community. In the absence of an effective system of controls at least till towards the close of the war, increasing demand exerted a strong and growing pressure on restricted supply. The relative stabilization of prices at the close of the war should be attributed to a large extent to physical controls.

*Prices and Production, 1945-51*

From the peak level attained in 1943-44 there was a sharp set-back in the next three years. Indices of agricultural production reached the lowest level of 94 in 1945-46 and that of industrial production receded from 115.7 in 1944 to 99.1 in 1947. There was some recovery in the subsequent years, but on the whole from the close of the war up to 1951 industrial production remained at a low level. Output of primary goods showed some improvement only in the year 1952-53. The general trend in the production of some of the agricultural and industrial commodities can be observed from the figures in Tables 55 and 56.

Several factors account for the adverse turn in production at the end of the war. In the first place, the demand for war materials by the government which figured so large in total production in the war years, came to a sudden end. As a result of the retrenchment in ordnance factories, army clothing factories, etc. and the cancellation of contracts for certain types of goods needed for the war effort after the end of fighting in 1945, the employment figures for 1946 showed a fall of about 7 per cent below the peak level of 1945. The decline in the number of working hours in factories

after the war, frequent labour disputes<sup>1</sup> and absenteeism of labourers also reduced the quantity of labour available for productive work. Secondly, machinery and plant in most of the industries had been overworked and had suffered much wear and tear during the war and were in urgent need of replacement. On the basis of an estimated average annual pre-war demand on replacement account of Rs. 8 crores, it was calculated in 1948 that for making good all the arrears of replacement and improvement India would have to import about Rs. 200 crores worth of capital goods in one or one and a half years time. It was stated that in the textile industry as much as 40 per cent of the machinery was due for replacement. The estimated requirements for obsolescence of the steel industry was Rs. 30 crores.<sup>2</sup> Other industries would have been less seriously affected, but that at the close of the war there was need for replacement of capital equipment on a considerable scale is obvious enough.

TABLE 55  
AGRICULTURAL PRODUCTION IN THE INDIAN UNION  
1945-51

| Commodity                    | Average<br>1936-37 to<br>1938-39 | 1945-<br>46 | 1946-<br>47 | 1947-<br>48 | 1948-<br>49 | 1949-<br>50 | 1950-<br>51 | 1951-<br>52 |
|------------------------------|----------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Foodgrains (a)<br>(000 tons) | 50019                            | 45736       | 46143       | 48244       | 47849       | 49685       | 45337       | 45733       |
| Oilseeds (b)<br>(000 tons)   | 4812                             | 5013        | 5148        | 5117        | 4502        | 5142        | 5078        | 4820        |
| Cotton (lint)<br>(000 bales) | 4146                             | 2167        | 2168        | 2188        | 1767        | 2628        | 2910        | 3133        |
| Jute (000 bales)             | 1904                             | 1459        | 1320        | 1658        | 2073        | 3089        | 3283        | 4678        |

(a) Includes rice, wheat, jowar, bajra, maize, ragi, barley, gram.

(b) Includes sesamum, groundnut, rape and mustard, linseed and castor seed.

(Source: *Report on Currency and Finance*, Reserve Bank of India, 1953-54.

<sup>1</sup> The total number of man days lost during the five years, 1946-50, was 56,524,900 against 18,954,560 in the previous five years covered by war. *Indian Labour Gazette*, Government of India, March 1954, p. 918.

<sup>2</sup> Records and Statistics, *Eastern Economist*, Vol. I, No. 1, March 1949, p. 20.

TABLE 56

## INDUSTRIAL PRODUCTION IN INDIA, 1944-51

| Industry                               | 1944  | 1945  | 1946  | 1947  | 1948  | 1949  | 1950  | 1951  |
|--|-------|-------|-------|-------|-------|-------|-------|-------|
| Finished steel (a)<br>(000 tons)       | 934   | 954   | 890   | 893   | 857   | 930   | 1004  | 1076  |
| Cotton piecegoods<br>(million yards)   | 4852  | 4711  | 3908  | 3762  | 4319  | 3905  | 3665  | 4076  |
| Jute manufactures (a)<br>(000 tons)    | 1115  | 1086  | 1088  | 1051  | 1088  | 946   | 835   | 875   |
| Paper (000 cwts.)                      | 1927  | 1964  | 2120  | 1862  | 1958  | 2064  | 2178  | 2638  |
| Sugar (000 tons)                       | 1091  | 967   | 923   | 901   | 1075  | 1001  | 2612  | 1115  |
| Cement (000 tons)                      | 2048  | 2209  | 1542  | 1447  | 1553  | 2102  | 2612  | 3196  |
| Coal raisings (000<br>tons)            | 26040 | 28716 | 28884 | 30000 | 29820 | 31452 | 31992 | 34308 |
| Electricity sold (mil-<br>lion K.W.P.) | 3212  | 3439  | 3348  | 3415  | 3721  | 3984  | 4103  | 4762  |

Figures from 1947 relate to the Indian Union.

(a) All figures relate to the Indian Union only.

(Source: *Monthly Abstract of Statistics*, Ministry of Commerce and Industry, Government of India.)

This, however urgent it might have been, could not be carried out in the years soon after the close of the war because of the general dearth of capital goods and constructional materials to install them. Thirdly, there was a serious shortage of raw materials caused by the partition of the country and the political disturbances following it and by the transport difficulties. As a result of partition, the Indian Union lost 76 per cent of the jute acreage and 23 per cent of the cotton acreage accounting in 1946 for about 80 per cent and 40 per cent of the respective total yields for undivided India. Production of rice and wheat in the Indian Union was 69 per cent and 65 per cent respectively of the total for undivided India,<sup>1</sup> while the population which the Indian Union had to support was 78 per cent. Owing to lack of understanding and agreement between the Indian

<sup>1</sup> Reserve Bank of India, *Report on Currency and Finance*, 1948-49, p. 68.



Union and Pakistan, the flow of two important raw materials,<sup>1</sup> jute and cotton, was severely restricted and the two major industries of India were considerably handicapped. The problem of scarcity of raw materials became much worse as a result of the non-devaluation decision of Pakistan in 1949. Attempts to make the country self-sufficient in respect of these two commodities did not yield any satisfactory results until recently.

Another important factor was the decline in the productivity of labour. In the evidence given by the employers delegation soon after the end of war before the U. P. Labour Enquiry Committee, it was emphasized that the efficiency of labour in the textile factories had declined by nearly 30 per cent.<sup>1</sup> In the Tata Iron and Steel Company, the average output of finished steel per employee declined from 24.36 tons in 1939-40 to 16.3 tons in 1948-49.<sup>2</sup> The condition might not have been so bad in other industries; nevertheless, the fact that there was a decline in the productivity of labour in general during this period cannot be disputed. A recent calculation made on the basis of productivity figures for some of the important industries in the country shows that between 1938 and 1948 labour productivity fell by more than 10 per cent.<sup>3</sup> This fall, however, cannot be attributed merely to the change in labour efficiency. Use of worn-out machinery, irregularity in the supply of raw materials, quality of management and organizational conditions are also important factors to be considered. It is also plausible to argue that in the face of controls, scarcity of goods and mounting black market prices, the labourers would have lost the incentive to work harder and earn more. High liquidity resulting from a higher wage rate, when it is coupled with a low marginal utility of money income, has no effect on the productive front.<sup>4</sup>

Nor was the attitude of businessmen conducive to increased production. Rising labour costs and cost of materials, difficulty of getting capital goods, labour troubles, the tax and the price policy of the government, the fear of nationalization and the dwindling profit margin, all these affected the confidence of the business classes. The significant fall in the number of capital issues and

<sup>1</sup> *Indian Finance Annual Number*, 1947, p. 68.

<sup>2</sup> *Eastern Economist*, 29th December 1950, p. 975.

<sup>3</sup> R. Balakrishna, *The Measurement of Productivity in Indian Industry* (1953), p. 35.

<sup>4</sup> A. J. Brown, *The Great Inflation* (1955), p. 244.

in their values from 426 and Rs. 163 crores in 1947-48 to 348 and Rs. 112 crores in 1948-49 and 263 and Rs. 75 crores in the calendar year 1950 is a rough indicator of the business prospects during this period.

As for agricultural production, the short-term measures of improvement, adopted during the war years and subsequently, proved of little effect. Between 1948-49 and 1951-52, the acreage under rice and wheat increased from 94.8 million to 98.8 million, but the output declined slightly. However, the increase in the acreage under commercial crops like tobacco, oilseeds, jute and cotton was attended with substantial increase in production also. The major cause for the decline in agricultural production in the post-war quinquennium was a succession of unfavourable seasons and natural calamities which affected almost all parts of the country. In 1946 food supply was seriously affected by cyclones, floods and draught in different parts of the country, particularly in Bombay, Madras and the Mysore State. Late monsoon in West India in the next year and the wheat rust in U. P. did serious harm to food production. In 1948 agricultural output fell because of unsettled conditions in East Punjab and West Bengal, floods in East Punjab and repeated monsoon failures in Madras and parts of Bombay. Bad seasons continued in 1949. In 1950 there were serious floods in Bihar, U. P. and the Punjab, earthquake in Assam and the rains failed partially in Madras for the fourth year in succession. These factors explain largely the decline in food production despite a small increase in the acreage under food crops.

Given the volume of purchasing power available in the country and the propensity to spend, the serious fall in production should naturally have caused a rise in prices. In actual fact this natural trend was strongly reinforced by both increasing cost of production and increased demand. Apart from transport difficulties and scarcity of materials, cost of production was pushed up by rising wage level which took place in the face of declining labour productivity. According to an estimate made by the *Eastern Economist* the proportion of total wage bill to total industrial income of organized industries rose from 21 per cent in 1943-44 to 39 per cent in 1946-47 and 44 per cent in 1949-50.<sup>1</sup> Indices of real earnings and productivity of industrial workers prepared recently by the Labour Bureau of the Government of India further illustrate this point (Table 57).

<sup>1</sup> *Eastern Economist*, 31st December, 1948, p. 1124.

TABLE 57  
LABOUR PRODUCTIVITY AND REAL EARNINGS

| Year | Index of<br>industrial<br>production<br>(a) | Index of<br>employ-<br>ment<br>(b) | Index of<br>real<br>earnings<br>(c) | Index of<br>product-<br>ivity<br>(d) | c/d × 100 |
|------|---|------------------------------------|-------------------------------------|--------------------------------------|-----------|
| 1939 | 100.0                                       | 100.0                              | 100.0                               | 100.0                                | 100.0     |
| 1940 | 108.1                                       | 103.1                              | 108.6                               | 104.2                                | 104.2     |
| 1941 | 114.3                                       | 120.6                              | 103.7                               | 94.8                                 | 109.4     |
| 1942 | 106.9                                       | 125.3                              | 89.0                                | 85.3                                 | 104.3     |
| 1943 | 112.2                                       | 132.8                              | 67.0                                | 84.5                                 | 79.2      |
| 1944 | 115.7                                       | 134.1                              | 75.1                                | 86.3                                 | 87.0      |
| 1945 | 112.5                                       | 141.5                              | 74.9                                | 79.5                                 | 94.2      |
| 1946 | 102.9                                       | 137.8                              | 73.2                                | 74.7                                 | 97.9      |
| 1947 | 99.1  | 136.6                              | 78.4                                | 72.5                                 | 108.1     |
| 1948 | 112.3                                       | 141.4                              | 84.4                                | 79.4                                 | 106.3     |

(Source: *Indian Labour Gazette*, November 1955.)

The last column in Table 57 giving the ratio of labour productivity to real earnings indicates the extent to which wages have risen since 1946 against a decline in productivity. Wages influence prices through their cost effect, their effect on incomes and also through their effect on expectations and willingness to spend. That the rise in wages in the period under review swelled up the cost of production and thereby influenced prices cannot be disputed. But the cost effect of a higher level of money wages should not be exaggerated. Of greater importance was the influence of increasing demand which became effective with increasing money incomes generated during the war period. Increase in population, relaxation of controls, release of the pent up consumer demand, construction and industrial expansion and the demand for both raw materials and capital equipment caused an upward shift in the demand curve for both intermediate and final goods in the post-war years. With tax measures failing to absorb larger purchasing power and with a fall in the rate of savings, disposable personal income tended to increase. It was the pressure of this increased income that helped in pushing up prices to a greater extent than the increased money cost of production. A comparison of the wage indices with the profit indices of this period would indicate the extent to which cost of production on the one hand and demand on the other influenced price level.

TABLE 58  
INDICES OF WAGES AND PROFITS, 1946-47 TO 1954-55

| Year    | Wages* | Industrial profits† | Prices of manufactured articles |
|---------|--------|---------------------|---------------------------------|
| 1946-47 | 208.6  | 229.2               | 271.9                           |
| 1947-48 | 253.2  | 191.6               | 286.4                           |
| 1948-49 | 304.0  | 259.9               | 346.1                           |
| 1949-50 | 340.3  | 181.5               | 347.2                           |
| 1950-51 | 334.2  | 246.6               | 354.2                           |
| 1951-52 | 356.8  | 310.5               | 401.5                           |
| 1952-53 | 385.7  | 190.6               | 371.2                           |
| 1953-54 | 384.6  | 261.2               | 367.4                           |
| 1954-55 | 381.2  | 292.0               | 377.4                           |
| 1955-56 | —      | 319.6               | 372.9                           |

(Source: \* *Indian Labour Gazette*, November 1955. Figures relate to calendar years beginning 1946—208.6. Base: 1939 = 100.

† *Eastern Economist*, Records and Statistics, April 1956.

Figures relate to calendar years beginning 1946—229.2.)

Chart VII based on the figures in Table 58 shows that in 1946-48 prices of manufactured goods went up rapidly along with wages and profits. The relative slopes of the wage curve and the profits curve in this period would suggest that demand was playing a relatively more important part in the uptrend in prices. On the other hand, it would appear that prices remained higher in 1948-50 mostly because of the higher cost of production resulting from higher wages. The decline in profits in 1948-49 should have been caused by the general recession conditions prevailing in the country and the fall in the off-take of industrial products.

#### *Prices and Production since 1951*

Since 1951, there has been a spectacular improvement in industrial and agricultural production in the country. The *Eastern Economist's* index of business activity, with the year ended August 1939 as base, went up from 105 in 1950-51 to 116 in 1952-53 and to 138 in 1954-55. The official index of industrial production (base 1951=100) steadily rose to 151.1 in 1959, while that of agricultural production (agricultural year 1949-50=100) reached the peak level of 123.6 in 1956-57, but receded to 114.6 in 1957-58 and again rose to 132.0 in the next year. For the year 1960-61 it is expected to reach 135.0. The details of this expansion are summarized in Tables 59 and 60.



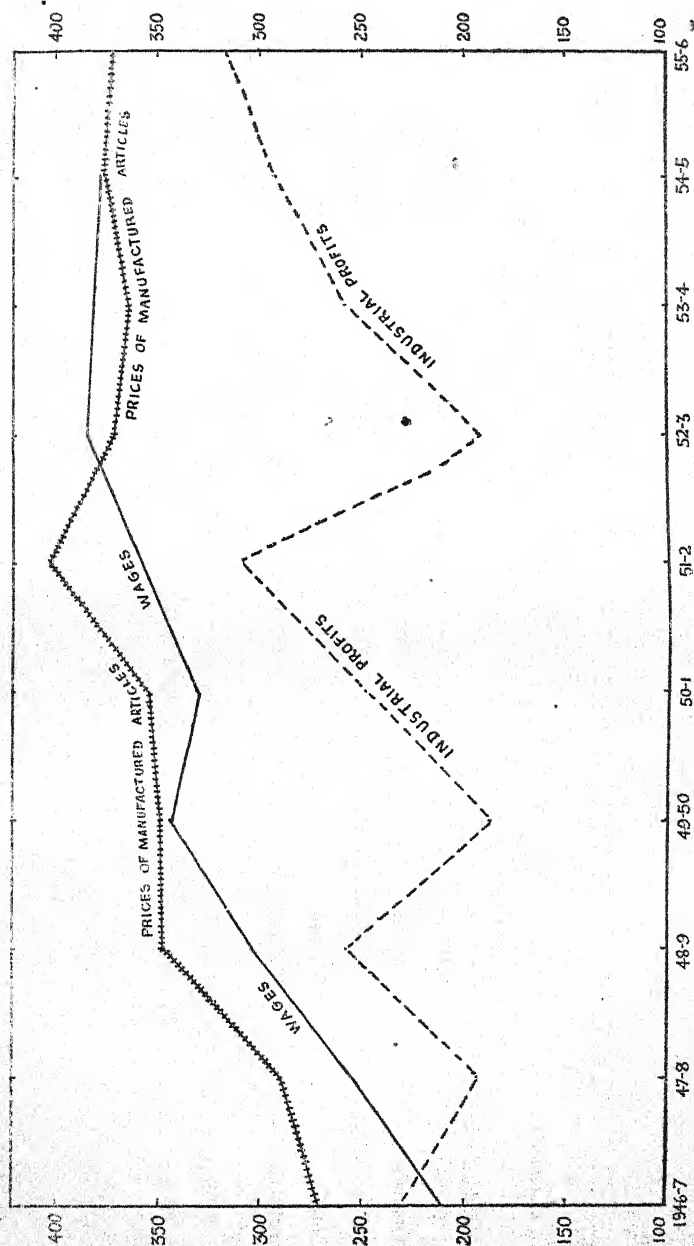


Chart VII: Indices of Wages, Profits and Price of Manufactured Articles, 1946-47 to 1955-56.

TABLE 59

## PRODUCTION OF FOODGRAINS AND INDUSTRIAL RAW MATERIALS IN INDIA, 1951-58

| Commodities                   | Units     | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | 1956-57 | 1957-58 | 1958-59 | 1959-60 | 1960-61* |
|-------------------------------|-----------|---------|---------|---------|---------|---------|---------|---------|---------|---------|----------|
| Foodgrains (Cereals & pulses) | 000 tons  | 51175   | 58266   | 68718   | 65801   | 65794   | 68748   | 62026   | 73500   | —       | 75000    |
| Oilseeds                      | 000 tons  | 4949    | 4659    | 5285    | 5877    | 5643    | 6176    | 5907    | 6920    | —       | 7200     |
| Cotton (Lint)                 | 000 bales | 3133    | 3194    | 3944    | 4227    | 3998    | 4735    | 4753    | 4710    | —       | 5400     |
| Jute                          | 000 bales | 4678    | 4592    | 3091    | 2928    | 4198    | 4288    | 4088    | 5200    | —       | 5500     |
| Tobacco                       | 000 tons  | 206     | 241     | 268     | 248     | 298     | 294     | 252     | N.A.    | —       | —        |

\* Likely achievement (Third Five Year Plan, Draft Outline, Government of India.)

(Source: Reports on Currency and Finance, Reserve Bank of India.)

TABLE 60

## INDUSTRIAL PRODUCTION IN INDIA, 1951-59

| <i>Commodities</i> | <i>Units</i>  | 1952 | 1953 | 1954 | 1955 | 1956 | 1957 | 1958 | 1959 |
|--------------------|---------------|------|------|------|------|------|------|------|------|
| Cotton cloth       | Million yards | 4598 | 4878 | 4998 | 5093 | 5304 | 5317 | 4927 | 4926 |
| Jute manufactures  | 000 tons      | 952  | 869  | 928  | 1027 | 1093 | 1030 | 1062 | 960  |
| Coal raisings      | Lakh tons     | 362  | 358  | 368  | 382  | 394  | 435  | 453  | 470  |
| Finished steel     | 000 tons      | 1103 | 1024 | 1243 | 1260 | 1338 | 1344 | 1296 | 1740 |
| Cement             | 000 tons      | 3538 | 3780 | 4398 | 4416 | 4928 | 4602 | 6068 | 6828 |
| Sugar              | 000 tons      | 1494 | 1291 | 1008 | 1595 | 1856 | 2008 | 2006 | 1920 |

(Source: *Reports on Currency and Finance*, Reserve Bank of India.)

There has been a rapid advance in the output of most of the agricultural and industrial products. Between 1950-51 and 1958-59 output of food grains increased from 50 million tons to 73.5 million tons or by 47 per cent. Production of rice went up from 20 to 30 million tons or by 50 per cent and that of wheat from 6.4 million tons to 9.7 million tons or by 52 per cent. The production of most of the food grains declined in 1957-58, but has revived since then. Equally significant is the improvement in the production of industrial raw materials and manufactured goods. Among industrial raw materials significant increases have been registered under oilseeds and cotton lint; the output of iron and manganese ore, coffee and rubber has risen substantially. Among manufactured products, jute manufactures improved by 27 per cent between 1950 and 1958, cotton cloth by 34 per cent and finished steel and cement by 30 per cent and 132 per cent respectively.

One of the most important factors responsible for this favourable trend in production is the interest taken by government in the matter of expansion of output and the encouragement given to

both agricultural and industrial production. It is worth observing that the new era of increased productive activity in the country has synchronized with the inauguration of the national development plan. Since 1950, government has attempted to ensure an increase in the production of food crops side by side with the two chief commercial crops of the country, jute and cotton. It was for this purpose that in August 1950 the Grow More Food Campaign was merged into an Integrated Production Programme. Two years later this short term Integrated Production Programme was made part of a long term Ten-year Land Transformation Programme which aims at the utilization of land on a rational basis with a view to developing to the maximum extent the available resources of land, water and livestock.<sup>1</sup> The Community Development Project started under the Indo-U.S. Technical Co-operation Agreement of January 1952 and the National Extension Service Schemes also have as one of their main objectives the increasing of agricultural production. The intensive Rabi Production Campaign launched in 1958 as an experimental measure in respect of wheat, barley, gram and jowar resulted in a marked increase in production. The main feature of the campaign was the stress on non-official participation and creation of enthusiasm among farmers. Also considerable importance has been attached to the construction of major and minor irrigation works, the popularization of improved methods of cultivation, such as the Japanese method of rice cultivation and the intensification of the land reclamation programme under the Central Tractor Organization. Measures to encourage production of cotton consist of remission of land revenue in respect of additional land brought under cotton cultivation, extension of irrigation facilities to cotton lands by State Governments, grant of loans for the purchase of fertilizers at subsidized rates, etc. The effect of these measures is seen in the fact that in the eight years since 1950-51 the area under wheat and rice increased by 13 million acres or about 13 per cent and that under cotton by 5 million acres or about 36 per cent. The acreage under sugar cane and jute, however, does not show any great increase partly because of the redirection of the acreage devoted to commercial crops during certain years as a result of the decline in their prices.

Expansion of industrial production has been made possible not only by the entry of government in the industrial field but also by

<sup>1</sup> Reserve Bank of India, *Report on Currency and Finance, 1951-52*, p. 34.



the encouragement given by government to the starting of new ventures and the expansion of existing ones. In addition to the establishment of government industrial units at huge cost, such as the Sindri Fertiliser Factory, the Chittaranjan Locomotive factory and others to meet the requirements of basic industrial materials, government took steps to encourage private enterprise by facilitating a regular supply of raw materials, by promotion of better understanding between capital and labour, by means of tax incentives and by promoting exports of finished goods. Towards the close of 1950, the Development Committee on Industries was appointed to assist in devising ways and means of stepping up industrial production and to plan the future development of industries. In 1952 a separate Ministry of Production was set up charged with the responsibility to plan and co-ordinate policy and to control and manage industries in the public sector. Financial facilities have been provided on an increasing scale to industrial concerns in the private sector by the setting up of the Industrial Finance Corporation in 1948 and by the subsequent widening of the scope of its activities. By liberalizing imports of raw cotton and by means of trade agreements with Pakistan, government sought to ensure an adequate supply of raw materials for the cotton textiles and jute industry of the country. Exports have been facilitated especially of cotton and jute goods by the lowering or removal of export duties. Recently, an Export Promotion Council was set up to increase, maintain and promote the exports of cotton cloth and yarn. To compensate for the rise in production costs in some industries, upward revisions have been made in the controlled prices of certain commodities, such as pig iron, steel and rubber. A noteworthy feature of recent trends in industrial production is the significant rise in the output of heavy and light industrial machinery and machine tools and the production of an increasing number of new items in the industrial and chemical group.

In general, the expansion in industrial output since 1951 has been achieved by the fuller utilization of existing plant capacity, by the starting of new industries and the development of old ones, by adopting improved techniques of production, by larger supply of essential raw materials and better export off-take in certain lines. The figures relating to capital issues give a rough idea of the expansion of industries in the country. The amount of capital issues for which permission was granted increased progressively from Rs. 74.75

crores in 1950 to Rs. 125.39 crores in 1955 and Rs. 422.97 crores<sup>1</sup> in 1958. In so far as the amount sanctioned for capital issues does not necessarily mean that the amount was actually subscribed, these figures have to be taken as only a broad indication of the trend. The extent of expansion that took place is also indicated by the increase in the number of joint stock companies registered in the country from 27,558 in 1950 to 29,779 in 1955 and in their paid-up capital from Rs. 723.9 crores to Rs. 983.1 crores.<sup>2</sup> But although the industrial base of the economy has thus been broadened and industrial output has considerably increased, there has not been a proportionate increase in factory employment. This, however, cannot be taken as an indication of sudden improvement in labour efficiency. It was more due to larger capital investment, better management, better off-take<sup>3</sup> of industrial products externally as well as internally, larger supplies of raw materials, improvement in transport, etc.

By and large, increase in production had a moderating influence on the general price level during the First Plan period. Rise in business activity, larger spendings by government for development purposes, deficit financing on a modest scale, higher levels of employment, larger annual investment, all these should have produced a multiplier effect, resulting in higher incomes and higher price level. In actual fact, up to 1954 the higher level of consumer spending appears to have been matched by the larger availability of output for consumption. In 1954-55 substantial increases in food production depressed food prices and brought down the general price level. Large investment outlays in the last few months of the First Plan brought into prominent relief the key position of agricultural production and food prices in the determination of the general price level and pointed to the need for the regulation of the supply and prices of food articles as the first step in the fight against inflationary price trends.

It is obvious that if the inflationary potential of a rise in money incomes is to be contained, it is necessary that total output should not only increase but increase in proportion to the rise in the level of spendings. The effect of a disparity in these two rates of increase

<sup>1</sup> This exceptionally large figure for 1958 is due to the consent given for a single share issue of Rs. 300 crores in the Government Sector.

<sup>2</sup> Government of India, Ministry of Finance, Department of Company Law Administration, *Progress of Joint Stock Company in India*, 1955.

has become patent in recent years. The average annual levels of agricultural and industrial production in the years 1957-59 represent a rise of only 5 per cent and 7 per cent respectively over the levels attained in 1956. Simultaneously money incomes in the three years have risen by 14 per cent and prices have gone up by about 10 per cent.<sup>1</sup> The rise in the prices of food articles and industrial raw materials has added to costs of living and has brought about a rise in money wages and costs of production. That higher costs have prevented industrial production from increasing to the extent it would have been possible otherwise cannot be disputed. Holding the price line thus becomes a measure of urgent importance if the vicious circle of slackening production and higher costs is to be avoided and the physical targets of output of the Plan are to be achieved.

In the last two decades, there were two upward phases in production trends in India with an intervening period of decline and stagnation. In the first period mostly covered by war, despite larger production, there was a rapid rise in prices due to the fact that, while production increased, there was an ever increasing draft on the nation's output for war purposes. The rapidly shrinking proportion of total output available for civilian consumption in the face of increased money incomes generated by higher levels of productive activity had the obvious effect of a marked rise in prices. In the early post-war years, rigidity on the production side combined with higher costs of production and the release of large spendable incomes resulted in a further rise in price level. In the earlier part of the last period mostly covered by the First Five Year Plan favourable trends in industrial and agricultural production had considerable influence on the price position. Relative stability in the price level in this period has to be attributed largely to the increase in the supply of agricultural and food materials against an expansion in money incomes. Since the close of the First Plan period although the upward trends in production have been maintained, sharp increase in government outlays on development unmatched by any corresponding increase in production has resulted in a further rise in prices.

<sup>1</sup> Average price level of 1957-59 compared with the level in 1956.

## CHAPTER X

### PRICES AND THE COST OF LIVING

THE AVERAGE consumer identifies inflation as a situation in which, as a result of a steady rise in the prices of consumer goods, he is forced to alter his consumption pattern by reducing or in some cases by forgoing the consumption of certain commodities. This need for restricting consumption obviously arises from the gap between the money earnings of the consumer and the prices of consumption goods. So long as money incomes of consumers as a class do not rise at all or rise with a considerable lag in relation to a rise in the price level, the consumer cannot buy or buy in the same quantity that assortment of goods to which he is accustomed. Thus from the consumer's point of view, inflation represents a widening gap between the purchasing power of anticipated money incomes and realized money incomes.

In the broad sense of the term, cost of living should indicate not only the money cost of the consumer goods and services which a particular class of individuals enjoys but also the real cost involved in a change in the consumption pattern brought about by the forgoing of the consumption of certain goods, the use of an inferior quality of goods, the consumption of a lesser quantity of the same goods, or the purchase of an unsatisfactory substitute, the sacrifice of leisure, recreation facilities, etc. In this sense the cost of living index should measure the money cost of maintaining a certain standard of life. In actual fact cost of living indices, however carefully they are prepared, do not attempt to measure real costs. Cost of living, as indicated by the cost of living indices, is nothing more than the percentage variation in the prices of certain consumer goods.

The economic significance of changes in the cost of living consists in two facts. Firstly, a general rise in prices by raising the cost of living of the community changes the consumption habits of the people and affects their economic efficiency. Secondly, to the extent that a rise in the cost of living of workers necessitates a frequent upward readjustment of the wage structure so as to keep the real incomes of the labourers from falling seriously, there is a rise in the cost of production which pushes prices further up and



sets in motion a wage price spiral. Normally, in an upward phase of the price movement, wage level fails to catch up with the general price level so that while prices go up and along with that the cost of living, the wage earning classes are squeezed.

It thus follows that the extent to which an inflationary price trend impinges on consumers depends on the nature of their earnings. Broadly speaking, borrowers and debtors and people with fluctuating incomes benefit, while creditors and fixed income earners lose. There is a redistribution of incomes in favour of the former category of income earners. Hence if an exact assessment is to be made of the effects of general price rise on the community, it is necessary to have not only separate cost of living indices for each category of income earners, but also an estimate of the average earnings of members in each category.\* In a country like India there is the additional problem created by the vastness of the country and the great inter-regional differences in customs and manners, food and consumption habits and earning power. There is also wide variation in the retail prices of the same consumption goods in different regions so that an all-India price index for the same class of income earners, even if it can be prepared on a scientific basis, would have little practical significance and value. However, regional indices prepared on scientific lines and based on a recognition of the varying importance of the same consumption commodities in the different localities would serve as a basis for making comparisons with regard to the effect of price changes on cost of living not only inter-regionally but also for the same region over time.

#### *Cost of Living Indices in India*

Although cost of living studies of as many income groups as possible are to be made in order to make a proper assessment of the burden of higher prices on the entire community, yet in practice in all countries such estimates have been confined largely to the factory labourers who constitute the wage earning class. This is due to two reasons. Firstly, in the budgets of such income earners the margin between income and outgo is so narrow or absent that a rise in prices seriously affects their consumption and standard of living and causes considerable hardship.<sup>1</sup> Secondly, the consumption pattern of factory wage earners is much simpler than that of

<sup>1</sup> Beney, M. Ada, *Cost of Living in the United States, 1914-36* (1936), p. 4.

the richer families and is easily amenable to measurement. On the other hand, since the major part of or the entire income is spent on consumption, cost of living studies relating to this class of income earners have a special value and significance as reflecting the effect of price rise on the general consumption pattern of the community. In India there is an additional significance attached to working class cost of living. More than 70 per cent of the population is in the villages which constitute a large non-monetized sector in the national economy. To the extent that markets and exchange are not well developed in most of the villages and a large proportion of the agricultural product is consumed at home without entering the market at all, cost of living indices for such a large proportion of the population would not only be difficult to compile but would also be meaningless. The number of people living in urban areas constitute 17 per cent of the total population. Of this, factory wage earners and their families form more than one-fifth. Thus cost of living studies relating to factory wage earners in India would be quite representative of an important section of the country's population.

Data relating to cost of living in some of the important urban centres in our country have been available for quite a long time. Before the Labour Bureau of the Government of India started publishing cost of living figures for urban centres in the country, the Provincial Governments were collecting and publishing similar data for more than a dozen centres in their respective areas. Of these the cost of living index numbers for industrial workers in Bombay published by the Labour Office of the Government of Bombay, for Nagpur published by the Central Provinces Department of Industries and for Madras by the Madras Government are more important. However, these index numbers are not strictly comparable with each other on account of differences in the base periods, dates of price collection and in the methods of construction, etc. The Bombay working class cost of living index number first published in 1921 was based on the aggregate consumption method, since in the absence of reliable data relating to consumption patterns no system of weighting could be adopted. To rectify this defect an enquiry into working class family budgets in Bombay city was made between May 1921 and April 1922 and later between May 1932 and June 1933. On the basis of these enquiries the series were revised in 1937 with July 1933 to June 1934 as the base period. In Madras the data collected by the enquiry into the family budgets of industrial workers

in Madras city conducted during 1935-36 form the basis for the construction of the cost of living index.

In order to prepare a more dependable cost of living series, the Government of India at the close of the war conducted an investigation into family budgets in some 28 centres. In all about 27,000 budgets were collected of which about 25,000 were accepted for tabulation. On the basis of these details, 24 working class cost of living index series were prepared for important industrial centres in the country. Most of these compiled by the Labour Bureau had 1944 as base year. Others collected by the State Governments had different base periods. Although the year 1944 could not be regarded as a "normal" year, the government justified its being adopted as the base period in so far as family budget enquiries were spread over some abnormal years of the war period. Subsequently when the Government of India compiled the all-India series of working class cost of living index, the nine component series compiled by the State Governments on different base periods were shifted to the 1944 base by simple arithmetical adjustment. The all-India index is actually the average of the average of the indices for the various centres previously calculated. In the first stage, average State indices were compiled by taking a weighted average of the indices for the centres included in each State, the weights being the factory employment in 1944 at these centres. In the second stage, a weighted average of the State indices was calculated, the weights being the total factory employment during 1944 in the various States, corrected for the effects of Pakistan. This weighted average of the State indices represented the all-India Average Working Class Cost of Living Index Number.

A recent "improvement" has been the shifting of the base to the year 1949. No fresh family budget surveys were made and the scope and method of compiling the index remained unchanged except that the weights for the various centres have been revised on the basis of factory employment figures during 1949 and that two more Part B States—Travancore-Cochin and Hyderabad—were included in the coverage. Also, of late, government have had some qualms of conscience regarding the use of the term "cost of living." In so far as what are called cost of living indices indicate nothing more than the extent to which retail prices of goods consumed by the average working class family have changed and do not purport to measure costs other than prices, the term "working class cost of

living index numbers" has been changed to "consumer price index numbers for the working class". It is claimed that this term reflects more appropriately what the indices really measure and conforms to international practices in labour statistics and to recommendation made by international bodies.

These minor attempts at reform and improvement have left unchanged the basic defects of the cost of living indices in India. And these are quite serious. Apart from the general defects which considerably discount the value of the series, the data relating to the war period suffer from certain specific defects. Many commodities of certain standard quality originally included in the indices became unavailable in the course of the war; in some cases the quality deteriorated significantly and some others because of very high prices went altogether out of consumption. Effective price controlled to the disappearance of quite a large number of commodities from the open market and the scarcity prices of such commodities during war time could not be brought within the scope of the index numbers. Also rationing restricted the supply of goods available for consumption and thus distorted the pattern of average consumption during the base period of the index series. Improvisations made in the index numbers to make them more correct did not improve their quality but only detracted from their comparability and usefulness.

The basic defects of the indices have not been removed in the post-war years. In the first place, the family budget enquiries on which cost of living indices are based are very much out of date. Relative price changes in the last 15 years or so have been quite significant and necessitate a revision of the weightage given to different items of consumption. In periods when the prices of essential consumption goods rise more than general price level, it is likely that the proportion of expenditure on necessities like food and clothing would go up, so that the weightage given for them at the base period is less than what later conditions would justify. Also, the fact that the indices were prepared on the basis of controlled prices reduces to a considerable extent their usefulness and value during times when free market and black market prices rule very much higher than controlled prices. An obvious illustration of this defect is the case of house rent which is assumed to be unchanged in different centres. In fact, more than 50 per cent of the prices included in the indices of many centres could not and did not change at all.



This would mean that the cost of living indices in general are a gross underestimate. Furthermore, the simple technique of averaging adopted by the government to compile a unified index for the whole of India, apart from its being theoretically unjustifiable, cannot be considered as of any real significance in view of the large inter-regional variations in consumption habits and price trends. The need for fresh family budget enquiries on a well-designed basis so as to lead to a series of cost of living index numbers representative of the country as a whole has been recognized by the government,<sup>1</sup> but only very recently have some preliminary steps been taken to conduct such a survey. The all-India series suffer further from the defect that they do not cover some of the States, and even in the case of States which have been included, the coverage of factory employment is not satisfactory in the case of Assam, Madras, Orissa, Punjab and West Bengal. The non-availability of middle class cost of living index numbers at least for some of the more important urban centres constitutes a serious gap.<sup>2</sup>

#### *Cost of Living Trends in Different Centres*

These defects of the cost of living index series available in India have been mentioned to indicate the extent to which they can be relied upon for purposes of analytical study. Conclusions arrived at on the basis of these figures have therefore to be accepted with these limitations in mind. Among the different indices available, those for Bombay, Nagpur and Madras are more reliable and we have them in a continuous series. On the basis of this data it is possible to make a comparative study of the relative effects of price changes on consumption and cost of living in different centres in the country.

Chart VIII shows that there has been on the whole a certain degree of uniformity in the general trend of cost of living and wholesale price level. The steep rise in the general price index between 1940 and 1943 is followed with a slight lag by the cost of living indices. There is, however, a variation in the rate of increase in cost of living in the different centres. Thus, while between 1941 and 1943 the general wholesale price index gained 121.7 points, the cost of

<sup>1</sup> *Indian Labour Gazette*, December 1952, p. 449.

<sup>2</sup> Middle Class Consumer price index numbers for Calcutta and Asansol have now been published by the Labour Bureau (Base: 1949=100).

TABLE 61

WORKING CLASS COST OF LIVING AND GENERAL PRICE INDEX  
NUMBERS IN INDIA, 1939-1951

(Base shifted to August 1939=100)

| Year            | Bombay | Nagpur | Madras | General<br>wholesale<br>price index* |
|-----------------|--------|--------|--------|--------------------------------------|
| 1939 (Aug-Dec.) | 103    | 104    | 106    | 125.6†                               |
| 1940            | 107    | 110    | 109    | 114.8                                |
| 1941            | 118    | 119    | 114    | 137.0                                |
| 1942            | 150    | 165    | 136    | 171.0                                |
| 1943            | 219    | 299    | 180    | 236.5                                |
| 1944            | 226    | 267    | 207    | 244.2                                |
| 1945            | 224    | 259    | 228    | 244.9                                |
| 1946            | 246    | 285    | 240    | 275.4                                |
| 1947            | 265    | 320    | 277    | 308.2                                |
| 1948            | 288    | 372    | 315    | 376.2                                |
| 1949            | 292    | 377    | 330    | 385.4                                |
| 1950            | 298    | 372    | 332    | 409.7                                |
| 1951            | 314    | 391    | 341    | 434.6                                |

\* Relates to financial years beginning 1939-40; up to 1946 sensitive series; thereafter general purpose series.

† Seven months ended March 1940.

(Source: *Indian Labour Gazette*, March 1954, p. 927.)

TABLE 62

WORKING CLASS CONSUMER PRICE INDEX AND GENERAL PRICE  
INDEX NUMBERS IN INDIA, 1951-60\*

| Year    | Bombay | Nagpur | Madras | General<br>wholesale<br>price index† |
|---------|--------|--------|--------|--------------------------------------|
| 1951-52 | 104    | 104    | 104    | —                                    |
| 1952-53 | 107    | 101    | 103    | —                                    |
| 1953-54 | 111    | 102    | 109    | 101.2                                |
| 1954-55 | 93     | 98     | 104    | 89.6                                 |
| 1955-56 | 89     | 98     | 100    | 99.2                                 |
| 1956-57 | 101    | 107    | 113    | 105.1                                |
| 1957-58 | 104    | 113    | 117    | 106.1                                |
| 1958-59 | 115    | 122    | 126    | 112.1                                |
| 1959-60 | 124    | 134    | 135    | 118.6                                |
| 1960-†  | 120    | 136    | 139    | 120.7                                |

\* Base: 1949=100.

† Base: 1952-53=100.

‡ First Six months average.

(Source: *Indian Labour Journal*.)

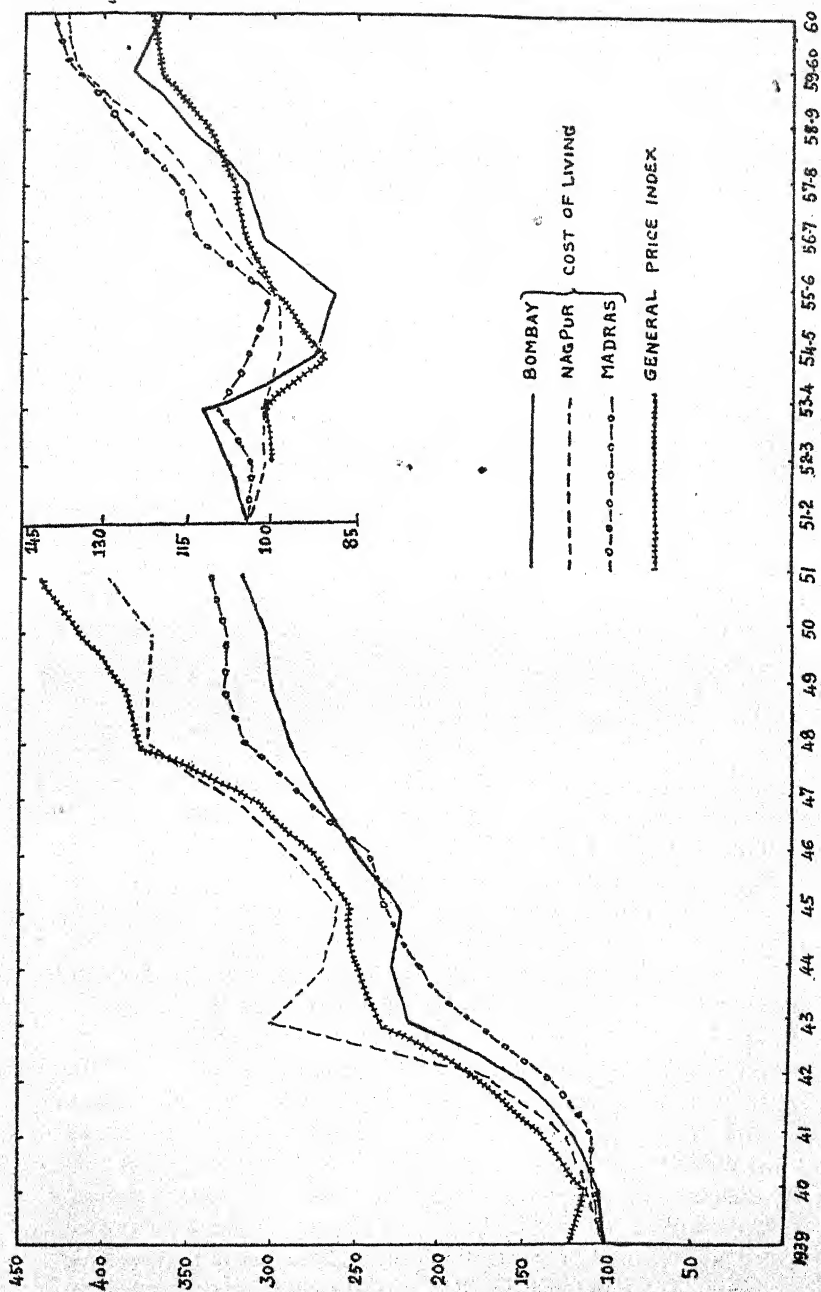


Chart VIII: General Price Level and Cost of Living in Bombay, Nagpur and Madras, 1939-60.

living index for Nagpur gained 189 points, that for Bombay increased by 112 points and for Madras by 71 points. In the last two years of war the general stability in price level is reflected in a similar position of the cost of living in Bombay, while in Nagpur there was a sharp decline by 40 points from the war-time peak reached in 1943. On the other hand, the uptrend continued in Madras with a slight slackening of the pace. In the early post-war period, in conformity with the advance in the general price level, cost of living in all the centres under review rose nearly at the same rate. Since 1948, however, there has been a slight divergence between the movements of general price level and the cost of living indices. Cost of living in all the centres has been more or less steady with a slight general tendency to rise. The sharp rise in the general price index between 1948 and 1951 and the downswing in 1951-52 seem to have had no appreciable effect on cost of living. Thus, Nagpur cost of living declined by 11 points in 1951-52 and that of Madras by 4 points, while cost of living in Bombay showed a slight uptrend. The steady rise in price level since 1955-56, particularly food prices as compared with the other prices in the general index, accounts for the more rapid rise in consumer price indices in these years.

#### *Movement in Retail Prices and Cost of Living*

Retail prices and especially retail prices of food articles determine directly the trends in the cost of living. It is therefore worth while to examine the relation between retail prices and cost of living trends in any particular urban area. Figures published by the Government of Bombay in the Labour Gazette may be used for this purpose.

The Bombay working class cost of living index prepared by the Directorate of Labour Information of Bombay has the period July 1933 to June 1934 as the base. The weights given to the five component groups in proportion to total expenditure have been as follows: Food 47; Fuel and Lighting 7; Clothing 8; House Rent 13; and Miscellaneous 14. Chart IX depicts the relative trends in the different components since 1939. In drawing inferences from this chart, some important limitations are to be borne in mind. In the first place, the rise in the cost of living is an underestimate in so far as it is based on controlled prices. Thus house rent with the exception of a slight rise in 1954 is assumed to remain constant.



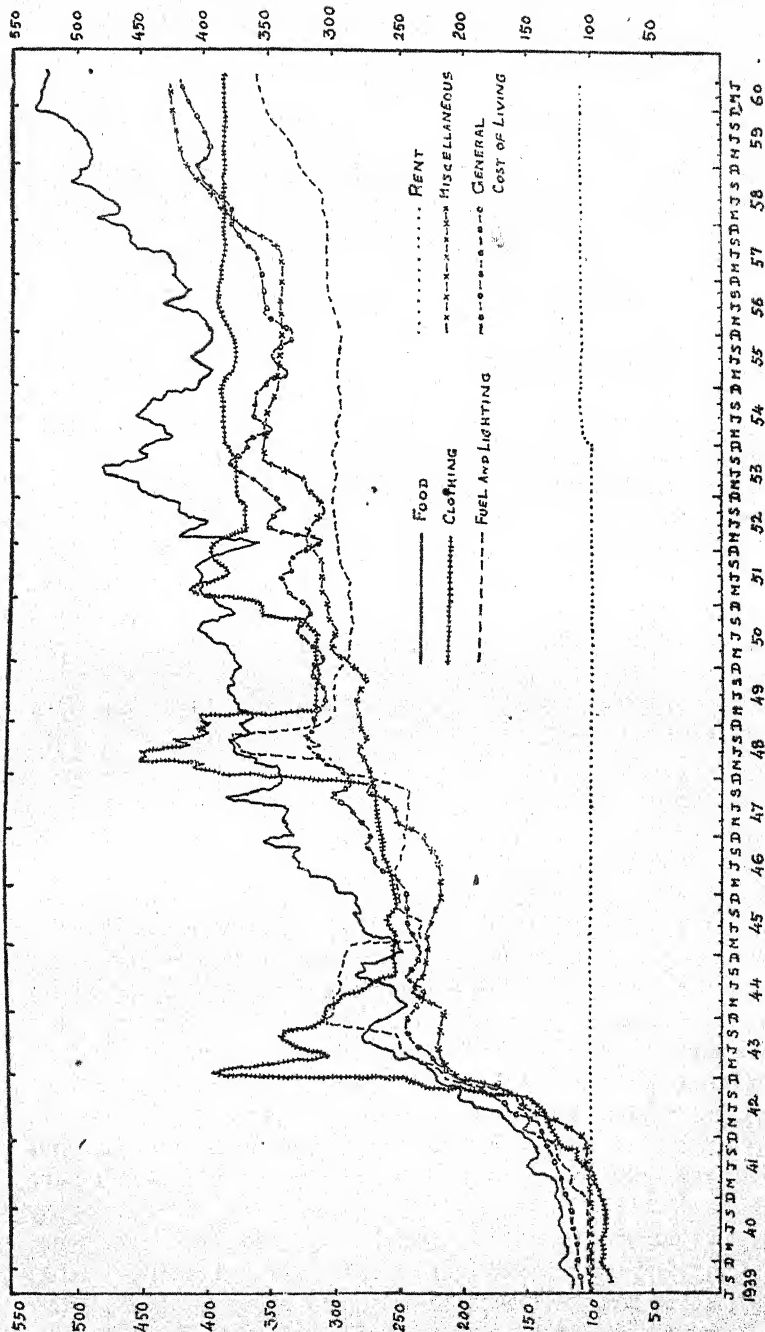


Chart IX: Bombay Working Class Cost of Living Indices since 1939 (Average Prices for July 1933 = 100).

The influence of this assumption should have been substantial in so far as house rent is given a weightage of 13. It should be repeated that the indices do not reflect the real cost involved in forgoing the consumption of certain commodities or in the payment of high black market prices. Secondly, it should be noted that the working class cost of living index for Bombay tends to understate the significance of the food group in comparison with other urban centres in so far as the proportion of expenditure on cloth, rent and other items is higher than elsewhere, so that the weightage given to food should be considered as correspondingly lower.

A scrutiny of this chart brings into relief the preponderant part played by the food group in determining the shape of the cost of living curve. The pattern of cost of living is set mostly by the movement of food prices. This is obvious in so far as 70 to 80 per cent of the family expenditure is incurred on food. It is, however, possible to observe that at certain points of time the movement in the prices of other components has to some extent modified the effect of food prices. Thus in 1942-43, the rate of increase in cost of living was higher than that of food prices because of the stronger pull exerted by the other components. Between September 1942 and April 1943, while food index rose by 36 points, the cost of living index rose by 55 points because of the spectacular rise in the other groups—cloth rising by 228 points, fuel and lighting by 61 points and miscellaneous by 64 points. The bulge between the food curve and cost of living curve between March 1945 and September 1947 should be explained by the relative stability of the other groups (due to controls), while the indices of the food group went up. Between these points of time, the index of food items increased by 50 per cent, while clothing and fuel and lighting remained more or less stationary; the miscellaneous group declined by 10 per cent between May 1944 and October 1945 and gained only 20 points between May 1944 and December 1947. In 1948, the index of clothing and fuel and lighting went up sharply, while the rise in cost of living was just in proportion to the rise in food, mostly because the miscellaneous items remained comparatively low and did not rise. Between the middle of 1949 and the end of 1950, cost of living did not show any great variation despite food remaining high, since the other items, clothing, fuel and miscellaneous, remained low and relatively stable. It should be observed that the miscellaneous group constitutes a very

important component. This category is made up of items, such as soap, medicine, supari, bidis, newspaper, travelling, etc. and is given a weightage of 14. Since the beginning of 1953, the movement in the cost of living index has been determined mostly by the trend of the food index. Between April 1952 and August 1953, food index rose by 49 points and cost of living gained 31 points. Subsequently, the rate of decline in the food index and cost of living has been more or less the same. This reflects broadly the conditions of food scarcity because of failure of seasons in the earlier part of this period and increased supply of food and fall in food prices in the latter part.

The disparity in the cost of living trends in the different centres should also be explained largely in terms of the variation in food prices. It may be seen from Chart VIII that cost of living has risen higher in Nagpur than in Bombay and Madras. Between June 1942 and September 1943, cost of living index in Madras increased by 41 per cent, that of Bombay by 61 per cent and Nagpur 123 per cent. That cost of food mainly accounts for this disparity in increase is shown by the fact that in this period, while in Madras and Bombay the food item showed a rise of 57 per cent and 60 per cent respectively, in Nagpur it registered a rise of 140 per cent. In Bombay, the highest point in cost of living for the year 1943 (248) was reached in October when food index stood at 282. In the first quarter of 1945 both indices had come down, general cost of living index to 225 and food to 253. This change was much less than in Nagpur where the general cost of living index receded by 114 points, from 361 in June 1943 to 247 in March 1945, or by 31 per cent. Again, this disparity was due to the food item which in Nagpur declined from 382 in September 1943 to 238 in March 1945, i.e. by 38 per cent. The same explanation holds good in the matter of difference in the rate of increase in cost of living between Bombay and Madras in the three years 1946-48. Between January 1946 and December 1948, cost of living in Bombay rose from 242 to 326 or by 35 per cent, while that of Madras went up from 225 to 322 or by 41 per cent. In the same period, food index rose by 34 per cent in Bombay and by 39 per cent in Madras. In the subsequent years, the pattern of movement of cost of living in the three centres, Bombay, Nagpur and Madras, has been more or less the same with the Nagpur index maintaining a constantly higher level with slightly sharper fluctuations.

*Cost of Living and Earnings of Labour*

Cost of living indices of working classes indicate only the trend in the prices of goods consumed by this class of people. They do not show the effect of the variation in prices on actual consumption and, therefore, do not indicate the actual burdensomeness of the rise in prices. In order to ascertain this, we have to find out how the consumption habits of the people are altered as a result of the rise in the prices of consumer goods. Given a certain increase in the price of consumption goods, it is possible for the consumers to buy and consume the same assortment and quantity of goods only if their money earnings rise in proportion to the rise in prices. The extent to which money earnings fall short of rise in prices indicates roughly the real burden of a price rise. Since 1939, in consequence of a steady rise in prices, wages of all types of labour have gone up and in addition labourers have been granted dearness allowances and bonuses. We have to examine the extent of relief afforded by this rise in money earnings to the working class against the pressure of a rising cost of living.

Statistics of earnings of factory workers are collected and published by the Labour Bureau of the Government of India. The data relate to those factories covered by the Payment of Wages Act, 1936. This includes most of the perennial industries which account for nearly five-sixths of the total factory employment in the country. Railway workshops and the groups "food, drink and tobacco" and "gins and presses", consisting mainly of seasonal factories do not come under the purview of the Act and details relating to them are not included in the computation of earnings. The scope of the statistics comprises all employees, including those in clerical service, who get less than Rs. 200 per mensem. Earnings include wages, bonus, allowances and other remuneration capable of being expressed in terms of money but exclude certain amenities provided by the employer, such as housing accommodation, supply of light, water, medical attendance, etc. and contributions paid by the employer to any pension fund or provident fund.

The figures in Table 63 illustrate the trend in average earnings since 1939. The indices have been calculated with 1939 as base.

It may be seen from Table 63 that between 1939 and 1953 the average earnings of factory labourers increased by nearly four times. Much of the increase had taken place in two main stages—



TABLE 63  
AVERAGE ANNUAL EARNINGS OF FACTORY WORKERS IN  
PERENNIAL INDUSTRIES, 1939-54

| Year | Earnings<br>(rupees) | Index no.<br>(1939 = 100) |
|------|----------------------|---------------------------|
| 1939 | 287.5                | 100.0                     |
| 1940 | 307.7                | 107.0                     |
| 1941 | 324.5                | 112.9                     |
| 1943 | 525.0                | 182.6                     |
| 1944 | 586.5                | 204.0                     |
| 1945 | 595.8                | 207.2                     |
| 1946 | 619.4                | 215.4                     |
| 1947 | 738.3                | 256.8                     |
| 1948 | 889.7                | 309.5                     |
| 1949 | 985.9                | 342.9                     |
| 1950 | 966.8                | 336.2                     |
| 1951 | 1035.6               | 360.2                     |
| 1952 | 1112.2               | 386.8                     |
| 1953 | 1110.9               | 386.4                     |
| 1954 | 1111.3               | 386.5                     |

(Source: *Indian Labour Gazette*. Figures up to 1947 from *Indian Labour Gazette*, March 1949. Figures for 1948-53 from *Indian Labour Gazette*, August 1955.)

first between 1941 and 1944 when average earnings went up from Rs. 324.5 to Rs. 586.5;<sup>1</sup> the second spurt took place in the period 1946 to 1949. The index numbers gained on the average 42.5 points in each year during this period. Increased demand for labour and relative scarcity combined with rise in prices secured higher wages for labour during the latter years of war. With the end of the war in 1945, there was widespread agitation for higher wages among industrial workers. The number of industrial disputes resulting in work stoppages increased from 820 in 1945 to 1,629 in 1946 and 1,811 in 1947. In 1948 and 1949 the number of industrial disputes recorded were 1,259 and 920 respectively. Most of the disputes arose on the issue of higher wages and allowances. Thus in 1946 and 1947, of the total industrial disputes numbering 3,440, as many as 1,452 were concerned with questions relating to wages,

<sup>1</sup> In 1944 the average earnings of workers in factories in India were more than double that in 1939.

allowances and bonuses. Since 1947, with the installation of popular governments in the States and at the Centre, government's attitude towards labour came to be one of greater sympathy. The recommendations of the Central Pay Commission and their implementation resulted in substantial wage increases to government employees. Private employers had to follow the trend and a large number of wage revisions were effected partly through direct negotiations between employers and employees and partly through the intervention of government conciliators, adjudicators, tribunals and courts. Annual bonuses have now become a regular feature of the wage bills in many of the major industries of the country and this has added substantially to the earnings of industrial workers.

The increase in earnings has not been uniform in the different regions and different industries. A welcome feature of the trend has been that the increase in earnings has been higher in those States and those industries which started on a low scale in 1939. In those States where the wage level was relatively higher in 1939, the subsequent rise has been less marked. Thus, as between the years 1939 and 1949, in Bihar where the index of earnings in the latter year was the lowest, the average annual earnings in 1939 were the highest. On the other hand, in Madras, where the index of earnings in 1949 was the highest, the level of earnings in 1939 was one of the lowest. Similarly, industry-wise, the index number of earnings in 1949 was higher than the average in textiles, chemicals and dyes, ordnance factories, mints and other miscellaneous industries in most of which the average earnings were below the all-industries average in 1939. But in industries where the earnings were relatively high in 1939, as for example in engineering, minerals and metals, paper and printing, wood, stone and glass, skins and hides, the rise in later years has been moderate. Thus in general the movement of average earnings in industries and in the different regions of the country has been such as to narrow down the inter-regional and inter-industrial differences.<sup>1</sup>

#### *Real Earnings*

In order to ascertain the effect of rise in prices on the standard of living of the workers, it is necessary to relate changes in money earnings to changes in cost of living. In other words, the trend and

<sup>1</sup> *Indian Labour Gazette*, February 1953, pp. 639-40.

variations of real earnings would indicate broadly the changes in the well-being of the industrial workers in the country. For purposes of such a study, it is necessary to have indices of cost of living and indices of average money earnings with the same base period. The Labour Bureau of the Government of India has recently attempted a study of this kind. The all-India cost of living index has 1944 as the base year. It was therefore necessary to convert the consumer price indices available for the years since 1945 from base 1944 to 1939. This was done on the basis of a series constructed for the purpose for eight selected centres of all-India importance, taking 1939 as the base year. These series with 1939 base were then corrected so as to bring down as low as possible the difference between individual values in the two series. The index of average money earnings of industrial labourers was also worked back so as to have 1939 as the base year. On the basis of these two sets of figures, the index of real earnings has been calculated by dividing the index of earnings by the all-India consumer price index. The results are shown in Table 64.

TABLE 64  
MONEY EARNINGS AND REAL EARNINGS OF FACTORY  
WORKERS IN INDIA, 1939-1954

| Year | Index of<br>earnings<br>(1939 = 100) | All-India consumer<br>price index<br>(1939 = 100) | Index of real<br>earnings<br>(1939 = 100) |
|------|--------------------------------------|---|---|
| 1939 | 100                                  | 100   | 100                                       |
| 1940 | 105.3                                | 97  | 108.6                                     |
| 1941 | 111.0                                | 107   | 103.7                                     |
| 1942 | 129.1                                | 145   | 89.0                                      |
| 1943 | 179.6                                | 268   | 67.0                                      |
| 1944 | 202.1                                | 269   | 75.1                                      |
| 1945 | 201.5                                | 269   | 74.9                                      |
| 1946 | 208.6                                | 285   | 73.2                                      |
| 1947 | 253.2                                | 323   | 78.4                                      |
| 1948 | 304.0                                | 360   | 84.4                                      |
| 1949 | 340.3                                | 371   | 91.7                                      |
| 1950 | 334.2                                | 371   | 90.1                                      |
| 1951 | 356.8                                | 387   | 92.2                                      |
| 1952 | 385.7                                | 379   | 101.8                                     |
| 1953 | 384.6                                | 385   | 99.9                                      |
| 1954 | 381.2                                | 371   | 102.7                                     |

(Source: *Indian Labour Gazette*, October 1955, p. 249.)

The trend in the above three series is depicted in Chart X. From this it would be seen that the rate of increase in earnings in the latter years of the war, though substantial, could not keep pace with the rise in consumer prices with the result that real earnings declined below the 1939 level. The lowest level seems to have been reached in 1943. The slope of the real earnings curve in 1946-49 indicates a substantial improvement in that period. In spite of this recovery, the real earnings index in 1951 was still 8 points below the 1939 level. Since then there was a further rise as a result of which the real earnings of the factory workers attained to the pre-war level nearly a decade after the close of the war.

Using the above method, it is possible to make a comparative study of the trend of real earnings in some of the important centres. It should, however, be remembered that with the available statistics and their limitations we can arrive at only very general and tentative conclusions. Data relating to cost of living, money earnings and real earnings of factory workers in Bombay, Madras, Madhya Pradesh and Uttar Pradesh are given in Table 65. Indices of earnings are based on the averages for the whole State, while cost of living relates to the industrial labourers in the cities of Bombay, Madras, Nagpur and Kanpur.

Figures in Table 65 show the disparity in the movement of real earnings in Bombay, Madras, Madhya Pradesh and Uttar Pradesh. In so far as indices of money earnings are based on the average for the whole State and the cost of living indices are for the cities, indices of real earnings found by deflating money earnings by the cost of living are an underestimate. Nevertheless, these figures indicate the general trend in the different centres and bring out the relative significance of changes in cost of living and money earnings. It appears that since 1944 real earnings in Bombay remained below the 1939 level up to 1947 (with a slight exceptional rise in 1944), in Madras up to 1946 and in Nagpur up to 1949. In Kanpur real earnings remained all along below the 1939 level. There is a general uptrend since 1946. This uptrend continued up to 1949 in Madras and Bombay, up to 1950 in Nagpur and up to 1952 in Kanpur. Real earnings declined sharply in Madras in 1950 and in Nagpur in 1951 and slightly in Bombay in 1950 and in 1951 in Kanpur.

It is, however, necessary to exercise much caution in interpreting the real earnings figures. Real earnings are dependent on two



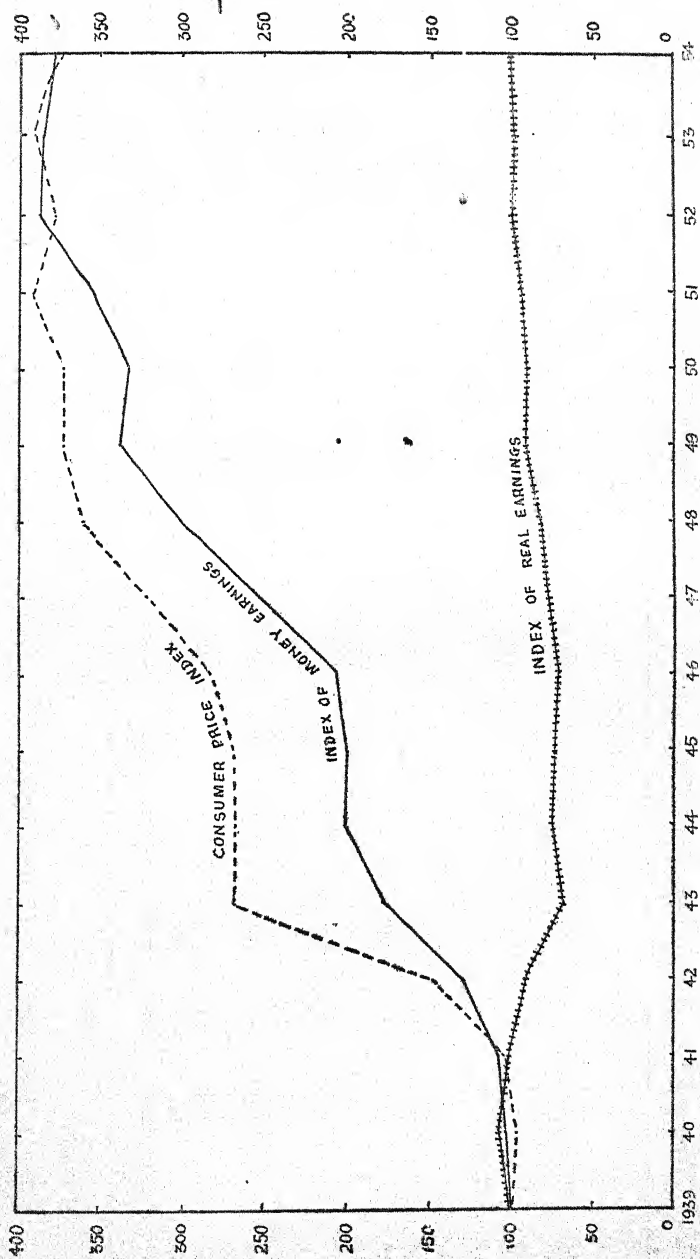


Chart X: Money Earnings, Cost of Living and Real Earnings of Factory Workers in India, 1939-54.

TABLE 65

## INDICES OF MONEY EARNINGS AND REAL EARNINGS IN SOME IMPORTANT CENTRES

| Year | Bombay           |                |               |                  | Madras         |               |                  |                 | Madhya Pradesh |                  |                |               | Uttar Pradesh    |                |               |                  |
|------|------------------|----------------|---------------|------------------|----------------|---------------|------------------|-----------------|----------------|------------------|----------------|---------------|------------------|----------------|---------------|------------------|
|      | (1)              | (2)            | (3)           | (4)              | (5)            | (6)           | (7)              | (8)             | (9)            | (10)             | (11)           | (12)          | (13)             | (14)           | (15)          | (16)             |
|      | Monthly earnings | Cost of living | Real earnings | Monthly earnings | Cost of living | Real earnings | Monthly earnings | Cost of living* | Real earnings  | Monthly earnings | Cost of living | Real earnings | Monthly earnings | Cost of living | Real earnings | Monthly earnings |
| 1939 | 100              | 100            | 100           | 100              | 100            | 100           | 100              | 100             | 100            | 100              | 100            | 100           | 100              | 100            | 100           | 100              |
| 1944 | 235              | 226            | 104           | 100              | 192            | 207           | 93               | 231             | 267            | 87               | 217            | 314           | 69               | 314            | 69            | 69               |
| 1945 | 224              | 224            | 100           | 100              | 204            | 228           | 89               | 256             | 259            | 99               | 224            | 308           | 73               | 308            | 73            | 73               |
| 1946 | 221              | 246            | 90            | 90               | 243            | 240           | 101              | 221             | 285            | 78               | 242            | 328           | 74               | 328            | 74            | 74               |
| 1947 | 267              | 265            | 101           | 101              | 338            | 277           | 122              | 276             | 320            | 86               | 284            | 378           | 75               | 378            | 75            | 75               |
| 1948 | 315              | 288            | 109           | 109              | 372            | 315           | 118              | 324             | 372            | 88               | 381            | 471           | 81               | 471            | 81            | 81               |
| 1949 | 337              | 292            | 115           | 115              | 439            | 330           | 133              | 386             | 377            | 102              | 427            | 478           | 89               | 478            | 89            | 89               |
| 1950 | 319              | 298            | 107           | 107              | 342            | 332           | 103              | 483             | 372            | 130              | 402            | 434           | 93               | 434            | 93            | 93               |
| 1951 | 349              | 314            | 111           | 111              | 378            | 341           | 111              | 406             | 391            | 104              | 419            | 451           | 93               | 451            | 93            | 93               |
| 1952 | 366              | 321            | 114           | 114              | 499            | 337           | 142              | 386             | 380            | 101              | 433            | 441           | 98               | 441            | 98            | 98               |
| 1953 | 364              | 346            | 105           | 105              | 451            | 358           | 126              | 453             | 387            | 117              | 432            | 453           | 95               | 453            | 95            | 95               |
| 1954 | 348              | 346            | 101           | 101              | 496            | 360           | 138              | 466             | 377            | 124              | 421            | 442           | 95               | 442            | 95            | 95               |

\* Nagpur

† Kanpur

(Source: *Indian Labour Gazette*; Base for cost of living August 1939 = 100. Base for money earnings and real earnings 1939 = 100.)

variables—cost of living and money earnings. The limitations of the data relating to these have already been stressed. A reference to Table 65 would show that cost of living indices in the different centres maintained on the whole an uptrend. On the other hand, there was considerable erratic variation in money earnings. This leads one to the conclusion that the violent changes in real earnings have to be explained mostly in terms of corresponding changes in the level of money earnings. Between 1947 and 1953, average annual earnings of workers in all the States increased by about 51 per cent, but there was considerable variation between the States. On the whole, Madras and Madhya Pradesh registered marked increases, while in Kanpur and Bombay the increase was moderate. The years in which there was a rise in earnings can be generally linked to the enforcement of awards granting increases in wage rates, allowances and bonuses in a number of industries employing large number of workers. Thus in Madras considerable increases were registered in the textile industry in 1947 due to the fixation of higher wage rates and dearness allowances under the Venkataramayya Award and again in 1949 when large bonuses were granted in important centres like Coimbatore, Madurai and Madras. In Madhya Pradesh, higher rates of minimum wages and dearness allowances were granted under awards during 1947 and 1948 in the textile industry, the effect of which is reflected in the increased average earnings during these years. The sharp rise in 1950 was on account of the payment in that year of 3 months' wages as bonus for 1947-48. In Bombay in 1952 when there was a substantial increase in earnings, the textile workers of Bombay and Ahmedabad numbering about 3 lakhs received profit-sharing bonus 50 to 75 per cent higher than in the previous year. However, as against Madhya Pradesh and Madras, the rise in earnings in Bombay since 1949 was comparatively smaller mostly due to the fact that the minimum wages and dearness allowances in the cotton mill industry in Bombay and Ahmedabad had previously been increased by the award of the Industrial Court in 1947, which made the average wage level already high.

On the other hand, the sharp decline in average earnings in certain years has to be attributed in a large measure to the expansion in the list of factories covered by the Payment of Wages Act, because of the change in the scope of the Factories Act, 1948. To the extent that the new establishments brought under the Act were generally small in size with lower wage level, the effect would be to depress

the level of average earnings. Thus in 1950 in Madras the largest decline in average earnings was in the textile industry and this was because a large number of small handloom factories were brought under the scope of the Factories Act. The same cause accounts for the marked fall in average money earnings of factory workers in Madhya Pradesh in 1951. The fall in the index in Bombay in 1950 was caused by the general strike in the textile mills for about two months in that year. This depressed the index for the textile industry as a whole and affected the average. If these factors are taken into consideration, it would mean that both the decline in Madras in 1950 and in Nagpur in 1951 and the rise in the previous years would have been less.

From this study of the trend of earnings and cost of living in some of the States, the following conclusions can be drawn. (1) In all the States during the war and in the years immediately after the end of the war, real earnings were depressed very much below the 1939 level because of high cost of living and the failure of wages to rise in response to rise in prices. (2) Since 1947, with certain exceptions, real earnings on the whole began to rise in all the States, the rate of increase being higher in some than in others. (3) For the country as a whole, the real earnings attained to the pre-war level only some eight or nine years after the war ended (See Chart X).

Data comparable to those on which calculation of real earnings is based are not available for later years. But figures relating to the basic wage and dearness allowances of workers in cotton textile mills at various centres of the country are available from 1954. It is thus possible to examine the effect of higher prices on this class of factory workers by comparing the rate of increase of money wages with the increase in prices of consumer goods. This is attempted in Table 66. It is seen that although average monthly earnings per head of workers in the cotton mills in these centres increased by 24 per cent between 1955 and 1959 this rise has been to a great extent offset by increase in the cost of living with the result that real earnings actually declined in 1956 and 1957 and has risen only slightly since then. In fact in 1959 real earnings were lower than in 1955 by 3 points.

The details given in Table 66 relate to workers in the towns who constitute less than 1 per cent of the total working population in the country. In the absence of statistical information it is not possible to make any estimate of the effect of rising prices on the rural popula-



TABLE 66

MONEY EARNINGS AND REAL EARNINGS OF COTTON  
TEXTILE FACTORY WORKERS, 1954-59

| Year | Money<br>earnings<br>per month* | Indices of<br>money<br>earnings† | All India<br>consumer<br>price index<br>number‡ | Index of<br>real<br>earnings |
|------|---------------------------------|----------------------------------|---|------------------------------|
| (1)  | (2)                             | (3)                              | (4)   | (3)/(4)                      |
| 1954 | 71.07                           | 100                              | 100   | 100                          |
| 1955 | 69.65                           | 98                               | 97  | 101                          |
| 1956 | 73.88                           | 104                              | 108   | 97                           |
| 1957 | 77.22                           | 109                              | 113   | 92                           |
| 1958 | 81.45                           | 115                              | 120   | 96                           |
| 1959 | 86.41                           | 122                              | 124   | 98                           |

\* Monthly minimum basic wage plus dearness allowance—average for Bombay, Nagpur, Madras and West Bengal.

† Indices of money earnings with 1954 = 100.

‡ The base for these indices is 1949 = 100. But for purposes of comparison the index number for 1954-55 is taken as 100.

(Compiled from *Indian Labour Journal*, January and March 1960.)

tion. It is, however, safe to presume that the conditions of agricultural labourers could not have been worse and probably could have been slightly better than that of their counterparts in the urban areas.<sup>1</sup> This assumption can be substantiated on two grounds. In the first place, a large proportion of production in the villages is for home consumption and in several areas of the country payments in kind for agricultural labour are still common so that the real earnings of agricultural labour could not have been depressed much. Furthermore, although no estimate has been made regarding the trend of earnings of agricultural labour in the war and post-war years, yet

<sup>1</sup> Consumer price index numbers for rural population in some of the centres in Andhra Pradesh, Madras and Kerala show that these indices declined to a greater extent than the general working class consumer price index in 1954 and 1955 and the rise since then has not been so high as in the case of the latter. *Indian Labour Journal*, January 1960, Table 30.

certain details relating to the level of money wages in rural areas in the Bombay State indicate a fairly steady and high rate of increase in wages in rural areas at least proportionate to the rise of wages in urban areas. Details of average daily rate of wages in the rural and urban areas of Bombay State, for field, skilled and unskilled labour are published by the Office of the Deputy Commissioner of Labour (Administrative) on the basis of the monthly returns received from the representative talukas in each district. The figures in Tables 67 and 68 extracted from these data illustrate the above point.

It may be observed from the figures in these tables that between 1950-51 and 1953-54 the wage level of field labour and unskilled labour increased to about  $3\frac{1}{2}$  times that in the previous year and in the case of skilled labour the rise was by about  $2\frac{1}{2}$  times. This increase is about the same as in the case of industrial labour. It may be noted that among the three categories of labour the rise in the wage rate for field labour was the highest.

TABLE 67  
AVERAGE DAILY RATE OF WAGES IN RURAL AREAS IN  
BOMBAY, 1949-53

| Year   | 1938-39 | 1949-50 | 1950-51 | 1951-52 | 1952-53 | 1953-54 |
|--|---------|---------|---------|---------|---------|---------|
| Field labour wages—Rs.                               | 0.28    | 1.32    | 1.35    | 1.36    | 1.31    | 1.34    |
| „ percentage increase over the wage rate in 1938-39  | —       | 370     | 382     | 385     | 369     | 378     |
| Unskilled labour wages—Rs.                           | 0.31    | 1.46    | 1.44    | 1.38    | 1.38    | 1.34    |
| „ percentage increase over the wage rate in 1938-39. | —       | 372     | 363     | 345     | 345     | 330     |
| Skilled labour wages—Rs.                             | 0.94    | 2.85    | 3.03    | 3.26    | 3.12    | 3.03    |
| „ percentage increase over the wage rate in 1938-39  | —       | 203     | 222     | 246     | 232     | 222     |

TABLE 68

AVERAGE DAILY RATE OF WAGES IN RURAL  
AREAS IN BOMBAY, 1955-1959\*

| Year†  | 1955 | 1956 | 1957 | 1958 | 1959 |
|--|------|------|------|------|------|
| Field Labour Wages Rs.                           | 1.27 | 1.27 | 1.52 | 1.69 | 1.89 |
| „ percentage increase over the wage rate in 1955 | —    | —    | 20   | 33   | 49   |
| Other agricultural labour wages Rs.              | 0.94 | 0.94 | 1.19 | 1.35 | 1.58 |
| „ percentage increase over the wage rate in 1955 | —    | —    | 27   | 44   | 68   |
| Skilled labour wages Rs.                         | 2.87 | 2.87 | 3.27 | 3.57 | 3.33 |
| „ percentage increase over the wage rate in 1955 | —    | —    | 14   | 24   | 16   |

\* Average for the villages, Junagadh, Bajwa and Rashin.

† Figures relate to the month of March in each year.

(Source: *Labour Gazette*, Government of Bombay.)

The figures in Table 68 relate to the years mostly covering the Second Five Year Plan. It appears that over the First Plan money wages of all the three groups of labour tended to recede slightly. In 1955 and 1956 they were substantially lower than in 1950-51. To some extent this situation should have been brought about by falling food prices. Since 1956 there has been a marked increase under all the three heads. Between 1956 and 1959 wages of field labour increased by 49 per cent and that of unskilled labour by 68 per cent. On the other hand wages of skilled labour was 24 per cent higher in 1958 than in 1956 but receded a little in 1959.

### *The Real Cost*

Since 1939, the purchasing value of the rupee fell by about 60 per cent at the close of the war and in the post war period by more than 75 per cent in 1951-52. With money earnings lagging behind prices, the purchasing power of the earnings of factory labourers over the necessities of life for health and efficiency declined by more than 25 per cent in the war period and remained 10 to 20





Similarly, the F. A. O. has estimated a decline in the calory value of food supplies per capita in India and Pakistan from 1970 in the pre-war years to 1570 in 1950-51.<sup>1</sup> The conclusion can therefore be made that till recently the standards of consumption remained considerably lower than before the war.

*Cost of Living of the Middle Class as Compared with  
the Working Class*

The general rise in prices affects different classes of income earners differently. The degree of hardship caused depends on the extent to which money incomes have increased or failed to increase as well as on the relative prices of articles consumed by members of each social strata. The articles of consumption among middle classes in India are not very much different from that of the working class, but the earnings of this group are even less flexible than wages of labourers. To this category would belong the large number of people employed in government and other services whose salaries have risen only to a slight extent since the outbreak of war and the amounts which they have been receiving in the form of dearness allowances and bonuses have no relation to the extent to which their cost of living has gone up.

Middle class cost of living indices for two centres, Calcutta and Asansol have been made available by the Labour Bureau of the Government of India with 1949 as the base year. It is possible to compare the relative effects of price changes over time on these classes of income earners as against working classes by using the method adopted by Professor Dudley Seers in making a similar investigation for the United Kingdom in 1949. According to him, what he calls the "progressive effect" of price movements from year to year can be measured by the following ratio:

$$\frac{\text{Middle class cost of living in year } T}{\text{Middle class cost of living in year } T-1} \div \frac{\text{Working class cost of living in year } T}{\text{Working class cost of living in year } T-1}$$

By "progressive effect" is meant the extent to which a given variation

<sup>1</sup> Records and Statistics, *Eastern Economist*, October 1953, p. 14.

in prices benefits working classes more than the middle class. A high ratio indicates a high progressive effect.<sup>1</sup> This formula would give the following results for Calcutta for the years 1951-59.

| Year  | 1950    | 1951    | 1952    | 1953    | 1954    | 1955    | 1956    | 1957    | 1958    | 1959 |
|---|---------|---------|---------|---------|---------|---------|---------|---------|---------|------|
| Middle class consumer price index number for Calcutta   | 100     | 102     | 97      | 96      | 94      | 92      | 99      | 105     | 108     | 107* |
| Year  | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | 1956-57 | 1957-58 | 1958-59 | 1959-60 |      |
| Working class consumer price index number for Calcutta† | 106     | 100     | 99      | 94      | 93      | 102     | 105     | 109     | 112     |      |
| Year  | 1951-52 | 1952-53 | 1953-54 | 1954-55 | 1955-56 | 1956-57 | 1957-58 | 1958-59 |         |      |
| Progressive effect                                      | 1.01    | 0.99    | 1.03    | 0.99    | 0.98    | 1.03    | 0.99    | 0.96    |         |      |

\* Average for first five months.

† Figures relate to financial years.

It would appear from the above set of figures that the trend of prices up to 1953-54 was on the whole less unfavourable to the working class than to the middle class. The recession in 1951-52 and the fall in food prices in 1953-54 benefited the working classes more than the middle class. Since 1954-55 the progressive rise in price level particularly food prices has clearly affected the working classes adversely. It is, however, not safe to conclude that in the last four or five years the middle class made any substantial gain in their standard of living as the progressive effect figures would indicate in so far as the earnings of the middle class have been more rigid than those of the working class, so that the large section of the lower middle class should have been forced to cut down consumption or change to substitutes which would have seriously affected their standard of living. Figures in the above table relate to the period since 1949. In the earlier years, conditions of the middle class should have been even worse. Thus, according to a calculation made by the

<sup>1</sup> Dudley Seers, "The Cost of Living, 1938-48," *Bulletin of the Institute of Statistics*, Oxford, May 1949.

*Eastern Economist*, cost of living index of the middle class in India (base August 1939 = 100) went up from 304.5 to 369.8 points between 1947 and 1949 while in the same period the Bombay working class cost of living index rose from 265.7 to 292.4 points. That is to say, while working class cost of living increased in these three years by 10 per cent, that of the middle class advanced by 21 per cent. On the basis of these figures, it is argued that if earnings of a middle class family had risen in the 10 year period 1940-50 by less than 3 times, it would have meant a curtailing of expenditure by about a fourth. The necessary cuts took the form of a considerable reduction in saving, in the expenditure on clothing and the miscellaneous group all of which should have resulted in a declassification in the social sense with the lower tier of the middle class moving down to the working class category.<sup>1</sup>

*Recent Trends in Cost of Living in India as Compared with Other Countries*

As compared with other countries, the rise in the cost of living in India during the war period was much higher. This was the result of a restriction in the supply of consumption goods and uncontrolled rise in prices. Table 70 furnishes details regarding the position of India in this respect in relation to other countries.

TABLE 70  
COST OF LIVING TRENDS IN INDIA AND OTHER COUNTRIES  
DURING THE WAR PERIOD  
(Base: 1937 = 100)

| Year | Australia | Canada | United Kingdom | United States | India* |
|------|-----------|--------|----------------|---------------|--------|
| 1939 | 105       | 100    | 104            | 97            | —      |
| 1940 | 110       | 104    | 121            | 98            | 105    |
| 1941 | 115       | 110    | 133            | 103           | 109    |
| 1942 | 125       | 116    | 143            | 115           | 122    |
| 1943 | 129       | 117    | 147            | 120           | 166    |
| 1944 | 129       | 117    | 151            | 122           | 226    |
| 1945 | 129       | 118    | 152            | 128           | 225    |

\* Bombay working class—Base: August 1939 = 100. Figures relate to financial years beginning 1939-40 — 105.

(Source: *International Financial Statistics* issued by the I.M.F.)

<sup>1</sup> *Eastern Economist*, 16th March 1951, pp. 443, 444.

At the end of the war, cost of living in India had risen by 125 per cent, while in the United Kingdom it rose by 52 per cent, in Australia by 29 per cent, in the United States by 28 per cent and in Canada by 18 per cent. While in other countries the rise had been rather gradual, in India there was a sudden spurt in 1943 and 1944, four-fifths of the total rise in cost of living in the war period taking place in these two years.

TABLE 71  
CONSUMER PRICE INDEX NUMBERS FOR INDIA AND  
OTHER COUNTRIES, 1950-59  
(Base: 1949 = 100)

| Year | India | U.K. | U.S.A. | Canada | Australia |
|------|-------|------|--------|--------|-----------|
| 1950 | 101   | 103  | 101    | 103    | 110       |
| 1951 | 105   | 112  | 109    | 114    | 133       |
| 1952 | 103   | 123  | 111    | 117    | 155       |
| 1953 | 106   | 127  | 112    | 116    | 162       |
| 1954 | 101   | 129  | 113    | 116    | 164       |
| 1955 | 96    | 135  | 112    | 116    | 169       |
| 1956 | 105   | 141  | 114    | 118    | 179       |
| 1957 | 111   | 147  | 118    | 122    | 183       |
| 1958 | 116   | 151  | 121    | 125    | 187       |
| 1959 | 121   | 152  | 123    | 127    | 191*      |

\* Average for first three quarters.  
(Source: *Indian Labour Journal*.)

In the years 1950-55 the cost of living in India remained more or less steady with an improvement in the real earnings of the working class. This was made possible by improved food position, increased industrial production and larger supply of consumption goods and a stable level of money earnings. As compared with other countries, India's position in this period appears favourable. The peak level before 1955 was reached in 1953 but in the next two years there was a decline. On the other hand it moved up in the U.K., while in Australia, in the U.S.A., and Canada the level remained higher than in India. The general rise in all countries up to 1953 has to be explained in terms of the Korean war and its aftermath and the stockpiling programme in the Western countries. But while in the two years



after 1953 the cost of living index receded in India, it went up further in the other countries. This is to be attributed to some extent to the measures taken by the Government of India to hold the price line when the Korean War had unleashed the forces of speculation and stimulated stockpiling in many parts of the world; but the major factor responsible for this downtrend was the improved supply position in the country. On the other hand the further rise in the U.K., and the higher levels at which it remained in the U.S.A., and Canada would indicate that the inflationary pressures generated by rearmament programmes continued unabated in these countries.

This, however, cannot be said of the trends since 1955. Although in the other countries under comparison the cost of living has continued its uptrend, there has been an appreciable acceleration in the rate of increase in India. Since 1955 and up to 1959 cost of living in the U.K., and Australia went up by 13 per cent and in the U.S.A. and Canada by 9 per cent and 10 per cent respectively, while in India the rise in the same years was as much as 26 per cent.

## CHAPTER XI

### PRICE CONTROL

THE PRECEDING chapters have been concerned with a review of the general pattern of price trends in India since 1939 and an examination of the factors which influenced prices and the effects of changes in prices on consumption and cost of living. Over the larger part of the period under review, the one distinguishing and obvious feature of price movement was its uptrend. The major decline that set in in the latter half of 1951 was initiated in the main by external factors but was later reinforced by substantial improvements in domestic production and supply. Of late, there has been again a rise in the general price level.

Changes in price level have to be explained largely in terms of the fundamental factors of demand and supply. Thus, increase in effective demand and relative deficiency in supply were the main forces behind the general rise in prices up to 1951. During war there was a phenomenal increase in government demand for resources for purposes of waging the war. The large spendings of the government resulted in a considerable expansion in the volume of money, which made possible an increase in effective demand from the community. Owing to the political exigencies of the immediate post-war years, the magnitude of government expenditure could not be reduced substantially and the needs of economic development in recent years have necessitated further large spendings by the government. On the side of supply, factors working towards a relative shortage include requirements of war which restricted the supply of goods available for civilian consumption, fall in imports due to shipping difficulties in the war period, adverse climatic conditions affecting agricultural output, decline in area as a result of partition, fiscal policy of the government, etc. Industrial production was affected by shortage of the raw materials, lack of capital equipment, inadequacy of technical personnel, tax policy of the State and general unsettled labour conditions. Defective distribution caused by transport difficulties and inter-State jealousies and speculative hoarding of consumption goods and industrial raw materials further aggravated the problem of defective supply.

However, movements in money supply and effective demand and

the vicissitudes in the supply situation do not adequately explain price fluctuations in the period under review. This is due to the fact that during this period the forces of demand and supply were not given opportunities of free play. Measures to control prices and regulate demand and supply were adopted soon after the outbreak of war and have continued, although in an attenuated form, up till now. The movement of prices in general, and of particular groups of articles in a form different from what would be indicated by the supply position and monetary and demand conditions, largely reflects the effectiveness or otherwise of the various control measures adopted by the government. It is the purpose of this chapter to review briefly these control measures instituted since the outbreak of war and up to 1951 and to estimate their effectiveness in holding down prices.

### *The Theory and Technique of Price Control*

In its wider sense the term price control would denote not only the direct measures taken by government to keep down prices but also all indirect measures which aim at preventing prices from rising or falling abnormally. The objective then would be the maintenance of a more or less stable price level. In theory, the operation of the price mechanism in a free enterprise economy in normal times results in a proper allocation of productive resources among competing enterprises so as to ensure a stable rate of economic growth, besides serving as an agency for the satisfactory distribution of the final goods among consumers. In actual fact, the unrestricted functioning of the price mechanism is seldom satisfactory and this necessitates some sort of control or regulation, particularly in abnormal times and to some extent even in normal conditions. Thus the dire need to suspend the operation of the free price mechanism at least for a temporary period becomes apparent in a time of war when the prime consideration of the government is to mobilize all available resources for purposes of war. The size of the resources being given, the result of this situation would be a diversion of the resources available for civilian consumption for war purposes. By virtue of its power over money supply the government can, by operating through the normal price mechanism, appropriate to itself the necessary resources, but increased spendings by the government, when there is difficulty of augmenting real resources, would

inevitably lead to an inflationary situation which would necessitate the government's spending ever increasing amounts to secure the same quantity of goods. In addition, this policy would bring about greater inequalities of income in the community and thereby deprive the price mechanism of any semblance of equity.

Even in normal times the existence of certain evils inherent in a free enterprise economy raises doubts as to whether the unrestricted play of the price mechanism would result in maximum social good. Thus wastes of competition, gross inequalities of income and the prevalence of mass unemployment, which are characteristic features of a free enterprise economy, point to the need for some system of controls and regulation which would reduce the chances of these evils arising. Inequalities of income and wealth place certain fortunate persons in an advantageous position in the matter of competitive demand for commodities. This also results in the production of certain types of goods mostly of the luxury kind which do not add appreciably to human welfare. Thus the economic objective of maximizing social welfare is more likely to be attained under a system of planned controls and regulation than under a system of unrestricted free enterprise.

At any rate, whenever circumstances necessitate large and rapid changes in the national economy involving mobilization of resources on a large scale by government, the reliance solely on the functioning of the normal price mechanism cannot be justified. Such a situation may arise when the national economy is disjointed by war; or when in normal peaceful times the government attempts to bring about rapid economic development which requires mobilization and allocation of real resources according to an overall pattern; or when there is large maladjustment in the balance of international payments; or again when a rapid downtrend in prices indicates the development of depression conditions. Abnormal movements of prices are symptoms of economic maladjustment. An inflationary rise in prices has to be controlled in order to prevent gross disparity in the real incomes of the people and safeguard the interests of the consumers in general; similarly a precipitate downtrend in price level is to be arrested to protect the producing class and to preserve the national economy.

Measures to control prices may be direct or indirect. Direct price control measures usually take three forms: (a) Price freeze, that is maintenance of relative prices at existing levels. This represents



usually the first step in a price control policy and is a sort of stop-gap arrangement in a situation when price rise is to be arrested quickly and when there is no time for the government to make a detailed study of the various factors affecting general price level and institute a scientific price policy. This was resorted to by most countries including India in respect of various commodities in the early years of the last Great War. While this method has the advantage of easiness to operate and immediate effectiveness, it has serious defects in so far as it does not take into account the dynamic nature of the economy and tends to make permanent a price system which is brought into effect by seasonal or temporary factors. (b) A second method is the cost plus method, according to which costs of production are taken into account and a suitable margin of profit is secured for the producer in price fixing. Its flexibility is its chief merit. But in safeguarding the interests of the producers it jeopardizes the consumers, for at best it only slows down the rate of increase in price and does not control it effectively. It is difficult to administer in so far as it is practically impossible to calculate the costs of production of different commodities in different industries and firms and adjust prices accordingly. (c) Lastly, there is the fixed ceiling method, in which the authorities responsible for price control fix maximum prices of various articles. This is more commonly adopted. In fixing maximum prices, both costs of production and the nature of demand for the commodity are considered. It should be equitable in the sense that it is neither beyond the means of the consumer nor uneconomic from the producer's point of view. When once the ceiling is fixed, the aim of the authorities would be to hold the ceiling as far as possible. They would be prepared to raise it only if the rise in costs is so much as to result in obvious inequity. Thus, while this method makes the price system more rigid than under the cost plus method, it has the advantage of ensuring greater stability in price level besides providing an incentive to producers to hold down costs as far as possible. This method also is, however, not free from defects. In course of time, the traders begin to believe that the maximum is the correct or normal price so that prices are artificially maintained at a high level even when conditions of supply which necessitated high prices have changed.<sup>1</sup> Furthermore, in common with all price fixing methods, maximum prices method has the defect of being inequitable to the extent that

<sup>1</sup> F. R. J. Jervis, *Price Control*, 1949, p. 98.

it fails to take into account the relative efficiency of different firms producing the same commodity. If maximum is fixed with reference to the costs of production of the more efficient firms, many of the marginal firms will go out and supply cannot be maintained. If it is fixed with reference to the cost of production of the average firm, then also there is the possibility of the disappearance of the marginal firm. To maintain supply, it therefore becomes necessary to subsidize the weaker firms. This sometimes results in a social evil in so far as an artificial prop is given to weaker firms which, in the normal course of economic progress, would have been weeded out.

These direct methods of price control are usually supplemented and supported by certain indirect measures. Such measures of price control are designed to manipulate the basic forces of supply and demand in such manner as to make the prices determined by the administrator economically valid. These would comprise restrictions on money supply, control of credit expansion and absorption of excess purchasing power through taxation and borrowing which would keep down effective demand; measures to increase domestic production and strengthen the supply position by restricting exports and encouraging imports and also means to facilitate better allocation of resources and distribution of goods by a system of rationing, provision of adequate transport facilities, etc. These methods are effective complementary measures when the policy is one of preventing prices from rising or bringing down the existing level of prices as well as of arresting a fall in prices below a minimum or raising prices from an existing low level. In the latter case, a minimum price is fixed which is supported by the preparedness of the government to buy the stock as well as by means of controlling production and supply.

Even when all these measures are adopted, price control can be really effective only if it is comprehensive and is rigidly enforced. It is obvious that if some commodities are left out of the scope of control and if there is great demand for these, there will be a shift in production from the controlled to the uncontrolled articles. If the uncontrolled articles happen to be of the luxury type or those which are not socially necessary, this substitution effect in production will adversely influence economic and social welfare. This possibility of substitution is greater when structural changes take place in the economy and during war.<sup>1</sup> The need for rigid enforcement

<sup>1</sup> A. J. Brown, *The Great Inflation, 1939-51* (1955), p. 144.

of the controls springs from the psychological influence which price control has on effective demand. If control is not strictly administered and is found to be ineffective, then expected prices tend to be higher than current prices. This increases the demand from retailers and consumers and thereby further weakens control.

### *The Nature of Price Control in India*

Since the beginning of 1941 right up to 1951 over a period of a decade, the general price level in India showed on the whole a persistent uptrend with substantial variations in the rate of rise in certain years. It was therefore inevitable that the measures which the government took to regulate prices were mostly of the anti-inflationary type with some exceptions as in the case of raw jute and raw cotton in the year 1943, when in view of a decline in the prices of these commodities, government took certain measures, such as restriction of acreage, fixation of minimum prices and an undertaking to purchase the commodities if their prices went below certain minimum levels. These price support measures were, however, quite exceptional in so far as during the whole period of ten years for almost all commodities a sellers' market prevailed so that the problem was mainly one of keeping down the prices in the interests of consumers.

A strict system of price control was not instituted promptly on the outbreak of war. Moreover, the series of measures adopted subsequently over several years were mostly of an *ad hoc* type, each being necessitated by a particular situation. This lack of an overall, well-planned and scientific scheme of price control is however understandable in view of the exigencies of the times when government's whole attention and effort were required for the operation of war and later for some years for the maintenance of peace and security at home. Nevertheless, when all the measures of control adopted by the government since the early years of the war are listed, it would be found that the government had actually put into use the complete kit of anti-inflationary tools. These included in the main direct measures to fix maximum prices of necessities like foodgrains, gram, vanaspati, sugar, gur, cotton textiles, etc. and industrial materials like raw rubber, raw cotton, raw jute, steel, cement and coal. These direct measures of price control were supplemented by comprehensive schemes of indirect control.

The supply position was sought to be improved by encouragement given to the increased production of foodgrains and manufactured goods in the form of tax and other incentives, facilitation of increased imports of necessities as well as producer goods, restriction of exports and also exchange control to prevent export of capital, to check speculation in exchange and to secure economy in the utilization of foreign exchange. Also, on the demand side purchasing power available for the community was controlled by monetary measures, such as restriction of credit, fiscal measures including taxation of excess profits and the narrowing down of budgetary deficits and attempts to mop up surplus purchasing power through borrowing and savings measures. Lastly, in order to ensure better distribution of raw materials and consumption goods, schemes for the allocation of industrial raw materials, such as steel, cement and coal, were put into operation in addition to the rationing of essential commodities like food, clothing and kerosene in urban areas.

To understand how far these measures were effective in controlling prices, it is necessary to keep in mind the important phases in the movement of prices and also the relative significance of the inflationary and deflationary forces that operated at each stage. The main phases in the price trends in the country between 1939 and 1951 as given in Chapters II and III are as follows.

(a) A sharp rise and fall between September 1939 and the middle of 1940 caused by speculative demand for commodities immediately after the outbreak of war and the reaction that followed it.

(b) From the latter half of 1940 to about the middle of 1943 there was a steady rise in the price level, the index of wholesale prices going up from 108.4 in August 1940 to 241.7 in June 1943. It is worth observing that in this period both industrial and agricultural production showed some improvement, the latter to a greater extent than the former. But the huge spendings of the government on account of war resulted in a spectacular increase in money supply. The total money supply excluding small coins increased from Rs. 532 crores in March 1940 to Rs. 1,198 crores in March 1943—an increase of more than 40 per cent per year.

(c) The period from the middle of 1943 to the last quarter of 1945 was one of relative stability in the price level, the general index of wholesale prices gaining only about 4 points between June 1943 and December 1945. In the same period there was a decline in indus-



trial and agricultural production, while money supply showed a moderate increase.

(d) Between 1946 and the first quarter of 1951 there was a rise in the general price level—phases of rapid rise in 1947-48 and 1950-51 alternating between periods of relatively moderate rise. Production in this period was at a low level and money supply did not show any great increase. Between March 1946 and March 1948 money supply increased from Rs. 2,121 crores to Rs. 2,237 crores only or about 3 per cent per year. This was the joint result of a diminution in the size of budgetary deficits and the appearance of large balance of payments deficits.

A similar break-up of the control measures chronologically with reference to the zeal with which they were put forward and administered and their effect on prices is possible. The early measures at control adopted between 1939 and 1942 had only a very limited influence on prices in the country. Between 1943 and 1947, price control was made more comprehensive and more strict. In 1947-48 there was the premature attempt at decontrol. In the years 1948-51, controls which were removed or relaxed in 1947-48 were reintroduced or tightened, and additional control measures were adopted to keep under check the inflationary forces released by devaluation and the military flare-up in Korea. These measures may now be examined in greater detail.

#### *Early Control Measures, 1939-42*

With a view to securing the defences of the country and prosecuting the war efficiently, the Government of India immediately after the outbreak of war derived for itself executive powers under the Defence of India Rules issued on 3rd September 1939. Soon after, by means of a notification, some of the powers were transferred to the Provincial Governments whereby they were empowered to fix the prices of certain necessities of life like foodstuffs, salt, kerosene oil and some cheaper qualities of cotton cloth. The maximum price for these articles was fixed at 10 per cent above the price prevailing on the 1st September 1939. This was in effect a sort of price freeze. A few days later, however, increase in costs of production or landing costs in the case of imports was permitted to be considered in fixing the maximum price.

Although these measures were taken immediately after the out-

break of war, controls as adopted at this stage were designed more with a view to helping government in the successful prosecution of the war than to reducing the evils arising from price distortion. In fact, the rise in prices was welcomed by the government on the ground that it would benefit the primary producers who were still recovering from the shock of the depression of the nineteen thirties; and the Finance Member expressed the opinion that there was no cause for fear in so far as prices of all groups were moving in unison.<sup>1</sup> That some of the financial and fiscal measures taken by the government at this stage had an anti-inflationary effect cannot be disputed; but the fact is that they were not designed to achieve that specific purpose. Thus when the Excess Profits Tax was introduced, equity was a more important consideration for the government than the control of prices. It was argued that financial justice required that additional taxation to finance war was to be imposed on those to whom war brought huge profits. This is equally true of some other measures adopted, such as those to control exports and imports. Conservation of essential supplies for civilian consumption in the country was only a minor objective of export control, the major one, being to prevent essential commodities reaching the enemy and to ensure supplies for the successful prosecution of the war.<sup>2</sup> Similarly, import control was instituted in May 1940 as a war measure. It involved licensing the imports of some consumer goods at first, but later in 1940 and 1941 was extended to unmanufactured and semi-manufactured steel and to machine tools and other goods. Its purpose was in the main proper utilization of limited shipping tonnage and conservation of foreign exchange, particularly dollar exchange.

Nor did the early Price Control Conferences take the matter seriously. The general opinion of the First Price Control Conference, held on the 18th October 1939, was that it was not at that stage necessary to prevent the rise in the price of agricultural products. A similar attitude was maintained by the next two Conferences. The burden of tackling the problem of price control rested principally with the provincial governments and the first three Price Control Conferences suggested that the arrangement could be left as it was and that the situation was not so serious as to need any action from the Centre.<sup>3</sup> However, with a sharp rise in the price

<sup>1</sup> Budget Speech, 1940-41.

<sup>2</sup> *Economic Controls in India*, Ministry of Commerce and Industry, p. 45.

<sup>3</sup> *Indian Finance*, 1942 (Annual Number), p. 19.

of foodgrains, especially of wheat in 1941, which had occurred in spite of practical cancellation of exports to Persia and other Middle East Asian countries and the lowering and abolition of import duties, government became alive to the realities of the situation and prepared measures to control the production, distribution and prices of foodgrains. In November 1941, statutory maxima of prices were imposed and wholesale transactions in wheat at rates above Rs. 4-6-0 per maund (spot delivery) at Lyallpur and Hapur were prohibited. However, this price could not be maintained because of shortage in supply. Government's attempts to procure supplies of wheat from Australia failed because of extension of war to the Far East. The maximum price of wheat was therefore raised to Rs. 5 at Lyallpur and Hapur and to Rs. 5-4-0 in Sind. To ensure increased production and better distribution, a Wheat Commissioner for India was appointed. Movement of wheat by rail from the producing centres to the consuming centres was sought to be regulated by issuing permits under a Wheat Control Order issued on the 30th April 1942. Next month the Food Grains Control Order was passed which made it incumbent on all wholesale dealers in foodgrains to be licensed and, shortly after, speculative dealings in foodgrains were prohibited. With a view to integrating all the activities in regard to the purchase, movement and distribution of foodgrains on an all-India basis, a Food Department was set up towards the close of 1942. These measures, however, met with only a limited success. Control measures only promoted large-scale hoarding and black marketing. From the middle of 1942 onwards, price control of wheat remained only in name, and early next year, owing to difficulties of securing supplies at controlled prices, the prices of wheat in the primary wholesale markets were decontrolled.

In the matter of industrial raw materials also, attempts were made to control production, distribution and prices. Statutory control over production and distribution of iron and steel was promulgated in August 1941. Price control over cement was introduced in August 1942 and on raw rubber also in the same year by the Indian Rubber Control and Production Order, under which all available supplies had to be sold exclusively to the Central Government or to parties nominated by them at prices fixed by government from time to time. To ensure an equitable distribution of available supplies at reasonable prices, control over sugar was instituted in April 1942.

A reference to the price indices of these years would show that these measures did not have any notable effect on the price front. It is worth observing that in 1942-43, a period which witnessed the first significant phase of price rise since the outbreak of war, there was some improvement in production. On the other hand, the rate of increase in money supply was the same as the rise in price level. Thus, while the wholesale price index rose from 145.9 to 220.1 in the twelve months from April 1942, notes in circulation also increased by about 55 per cent in the same period. It is therefore clear that the rise in general price level was due largely to the heavy spendings of the government and the phenomenal increase in money supply against which the belated and rather half-hearted control measures adopted by the government had little effect.

Apart from the fact that government came to realize the seriousness of the situation only after prices had substantially risen, there were other factors which prevented a successful working of controls. The nature of the economy is such that an efficient system of physical controls cannot easily be instituted. The vastness of the country, the break-down of the transport system, the illiteracy of the large majority of people, lack of co-operation from the community in general and the business classes in particular, and the fact that wholesale and retail trades were only imperfectly organized, stood in the way of the efficient operation of the control mechanism. Most of these obstacles remain today. There is still a large non-monetized sector of the economy. Production is carried on by millions of petty agriculturists or small producers who turn out a wide variety of articles which cannot easily be standardized. Apart from these, there are two basic factors which make it difficult to operate food control in the urban areas. The food supply in the towns comes from the surplus margin in the production of about 50 to 55 million subsistence farmers. This surplus is limited and would come to the markets in the towns only if the village producers want money. If they have it, and the value of it has fallen, there is no longer the incentive to restrict consumption and move food materials into the towns. Moreover, even if substantial amounts of agricultural materials come to the towns, physical controls have to be operated only through the assembly markets which are still unorganized and limited in number. Another serious problem was presented at the early stages of price controls in India by the attitude of the Provincial Governments. There was no co-ordination between the



action taken by the Provinces in respect of price control. Every Province showed itself to be interested in price control only so long as it did not affect its own interests in a particular product. Thus the Punjab was opposed to the price control of wheat, Bengal of jute and Bombay and the Central Provinces of cotton textiles. At one time, the Punjab banned export of wheat, which had to be removed by the intervention of the Central Government. Similarly, the Central Government had to put down profiteering by surplus provinces like the Punjab and Sind at the expense of deficit provinces. It is therefore not surprising that in the absence of co-operation from the people and from the provincial governments, the early control measures of the government did little to keep down the price level.

*The Adoption of Strict Control Measures and Their Effect  
on Prices, 1943-47*

The spectacular rise of prices in 1942-43 drew the attention of the government to the need for instituting an efficient system of price controls. The year 1943 thus marks the beginning of a period when almost all departments of the national economy came to be strictly controlled. Measures which had been adopted in previous years but which were half-heartedly executed, received a new life, while fresh ones were introduced which considerably expanded the scope and increased the efficiency of economic controls in the country. The various control measures adopted by the government involved a three-pronged attack on the price front: firstly, extension of direct price control; secondly, improvement of the supply position in the country; thirdly, absorption of excess purchasing power. In May 1943, a new Department of Industries and Civil Supplies was created by the Central Government and entrusted with the task of instituting a comprehensive control over the production and distribution of cotton textiles. For this purpose the Cotton Cloth and Yarn (Control) order was issued in June 1943. Also at the same time a Textile Control Board was set up to advise the government in the working of controls on production, trade and prices of cotton yarn and cloth. The method of fixing ceiling prices was considerably extended and attempts were made to bring down the maximum prices wherever possible. Provincial Governments were empowered to fix maximum retail prices of certain commodities

and to facilitate enforcement of this they were given powers to compel merchants to declare their stocks, to undertake a drive against hoarding and if and when necessary to introduce a system of licensed dealers. The Hoarding and Profiteering Ordinance (October 1943) authorized the government to fix maximum prices of any article. Accordingly, maximum prices of several manufactured consumption goods like mill stores, footwear, fountain pens, razor blades, medicines and drugs were fixed. By the middle of 1944 ceiling prices were extended to new classes of goods such as vegetable oil products, and under the Consumer Goods (Control and Distribution) Order reduction in ceiling prices for certain necessary goods including cotton cloth was effected. Price control was made quite comprehensive and scarcely any field of trade or business was left untouched.

In addition to the extension and tightening of price controls, steps were taken to improve the supply of commodities required for home consumption, by encouraging larger production and better distribution, tightening up of export controls by imposing restrictions on the export of a variety of articles like textiles and leather goods and by the liberalizing of the import of several consumer goods. As a result of the Hydari Mission to the United Kingdom, arrangements were made for securing larger imports of consumer's goods from the United Kingdom and for reducing the overall demand of the Defence Services on Indian production. Besides, government undertook to import raw materials, stores and machinery required for the manufacture of consumer's goods on government account for subsequent sale to industry in the country. The gradual repatriation of foreign troops, following the cessation of hostilities, relieved not a little the strain on the country's supplies in the latter part of 1945.<sup>1</sup> The Textile Industry (Control of Production) Order of June 1945 brought about standardization of mill output and made a beginning in the direction of rationing of cloth in Bombay and Delhi. Import control was relaxed and under the new Open General Licence introduced by a notification early in 1946, decontrol was extended to a number of imports including important industrial requirements. To counteract shortage in supply resulting from speculative hoarding, hedge contracts in raw cotton were banned in May 1943. This was followed up later on by prohibition of dealings in forward contracts (excluding delivery

<sup>1</sup> Reserve Bank of India, *Report on Currency and Finance*, 1945-46, p. 19.

contracts) in cotton cloth and yarn. Soon after, the ban in futures markets was extended to all commodities and bullion. About the same time, the Bombay Government asked the authorities of the Bombay Stock Exchange to take effective steps to curb speculation in stocks and shares. In order to prevent capital resources from being frittered away in speculative ventures and to ensure their flow into channels that would help prosecution of the war and lead to the production of essential consumption goods, control over Capital Issues was instituted in May 1943 by the Capital Issues Control Order.

Measures to absorb the excess purchasing power in the community included the institution of compulsory deposit scheme under the Excess Profits Tax and Income-Tax and the intensification of the small savings campaign. In order to mop up purchasing power from the hands of groups not accustomed to invest in securities, the Reserve Bank commenced operations of the sale of gold in the latter part of 1943. This gold had been provided by the Governments of the United Kingdom and the U.S.A. from their own resources and the sale proceeds were used by them towards their war expenditure in India. The import of this gold reduced to some extent the gap between India's exports and imports and its sale in the country helped to some extent in the absorption of excess money supply with the public. The strengthening of the defence loans scheme which had been started in 1940 also served the same purpose.

Some of the large number of control orders made under the Defence of India Rules were due to expire on the 1st October 1946. In view of the political and economic situation in the country as well as outside, it was found necessary to retain the powers under which these emergency control measures were adopted. This was done by the Emergency Provisions (Continuance) Ordinance issued on the 25th September 1946. On the same date, the Essential Supplies (Temporary Powers) Ordinance was issued which empowered the government to continue central control over trade and commerce and over the supply and distribution of foodstuffs, other necessary goods like cotton textiles, and most of the industrial raw materials including petroleum, coal, iron and steel. However, with the expiry of the Defence of India Rules, the Hoarding and Profiteering (Prevention) Ordinance of 1943 and the Consumer Goods (Control and Distribution) Order of 1944 were allowed to lapse. But some of the powers under the Ordinances were delegated to Provincial Governments.

The fact that between April 1943 and the end of 1945 the general price level remained on the whole stable despite a deterioration in both agricultural and industrial production and an abnormal expansion of money supply is an indication of the extent to which the various price control measures adopted in the last two years of war proved effective. In this period the index number of general wholesale prices moved up from 230.5 in April 1943 to 251.4 in December 1945. The control mechanism had by this time passed the long period of testing and trial and the economy of the country had also been fully geared to the needs of war and the economic pattern of the country itself had undergone a change, with the result that the different sectors of the nation's economy had become more amenable to control. The runaway tendency of prices which started in the second quarter of 1941 was arrested and an element of stability was restored in the price structure of the country.

*The Abortive Attempt at Decontrol, 1947-48*

Since the close of the war in 1945, opinion in certain sections of the community was gaining strength that there was no longer the justification for the retention of controls. It was argued that the various physical, financial and fiscal controls hampered the working of the economy and in their absence production would adjust itself to demand, hoarding and black marketing would end and prices would return to their normal level. Government also seems to have been influenced largely by this feeling and announced towards the close of 1947 their policy of gradual decontrol. Controls on the production and distribution of pulses and sugar were the first to go. Soon after, foodgrains were freed from controls and early next year cotton, cotton cloth and yarn were decontrolled and the controlled prices of steel, cement and coal were revised upward in consequence of their increased cost of production.

Although some theoretical support can possibly be given to the stand taken by the government in the matter of decontrol in 1947, the fact remains that a more inopportune time could not have been chosen for the relaxation and removal of controls. The setting up of the Commodity Prices Board in February 1947, which had a short-lived existence of about seven months, to advise the government in the formulation and administration of an appropriate and consistent price policy did not produce any tangible results.



The supply position in the country had considerably deteriorated. With growing industrial unrest, dislocation caused by communal disturbances and shortage of raw materials, industrial production declined. Production of cotton piecegoods in 1946-47 was 3,863 million yards as against 4,651 million yards in 1945-46 and 4,726 million yards in 1944-45. Sugar production had also fallen to a low level. The total output of cereals in 1945-46 and 1946-47 was much below the average. Supplies from outside had also fallen as a result of the restrictive import policy which the government adopted in order to conserve foreign exchange. Internal distribution was hampered by transport difficulties. Large expenditure by the government in connection with refugee rehabilitation work and on developmental schemes resulted in substantial deficits in the budget. In the financial year 1947-48, money supply with the public increased by Rs. 109 crores from Rs. 2,128 crores to Rs. 2,237 crores. This expansion in purchasing power combined with large pent up demand added to the inflationary pressure in the country.

It is not therefore surprising that soon after controls were removed, prices registered a sudden uptrend and the Economic Adviser's general index touched a new peak level of 389.6 in July 1948. This rise was all round. Between November 1947 and July 1948, the price level of semi-manufactured articles went up by 33.9 per cent, food articles by 32.5 per cent, manufactured articles by 30.7 per cent, industrial raw materials by 19.1 per cent and the miscellaneous group by 16.6 per cent. It is to be noted that the rise was most marked in the case of decontrolled items. In the food group, cereals showed an increase of 49.4 per cent; oil cakes and cotton yarn in the semi-manufactured articles group of 99.1 per cent and 76.3 per cent respectively. Textiles in the manufactured articles group went up by 42.5 per cent and fibres and oilseeds in the industrial raw materials group by 30.5 per cent and 9.9 per cent. The wholesale prices of coarser varieties of cloth in Bombay at their peak levels stood at 100 per cent above the ex-mill price agreed to in January 1948 under the system of voluntary price control, while the rise in the finer varieties ranged up to 250 per cent. The price of cereals like wheat and rice increased by 100 to 250 per cent above the pre-control levels in some deficit areas.

Decontrol thus proved to be a costly experiment. That it was an unwise step and ill-timed cannot be disputed. In view of what has

been stated above, the argument raised in some quarters<sup>1</sup> that decontrol was not responsible for the full rise of 29 per cent in price level, that had it not been partial but comprehensive and had it been given time to take effect it would have resulted in increase in production and consequent easing of the situation and that even in the short time when some controls were in abeyance there was a substantial increase in production in commodities like textiles and sugar seems unconvincing. While it is indisputable that decontrol resulted in a sharp rise in prices, it is doubtful whether this ill-timed experiment was responsible for any substantial increase in supply.

Wisdom came after the event. Realizing that decontrol had only resulted in an activation of latent inflation, government by the end of July 1948 decided to reverse its policy. Since the sharpest rise had occurred in cloth prices, recontrol was first applied to this commodity. On the 30th July 1948, government announced their decision about the fixation of fair ex-mill prices for cloth and yarn, the stamping of such prices on all cloth and yarn and the allocation of cloth on a quota basis to Provinces and States subject to a ceiling on the margin to be charged by retailers. Besides, floor and ceiling prices were fixed for raw cotton. As regards food, the revised food policy aimed at the reintroduction of controls over prices, and procurement and distribution in respect of all major foodgrains. It also envisaged the cordoning off of surplus, self-sufficient and deficient areas, procuring of surpluses by government agencies, payment of subsidies to deficit Provinces on imported foodgrains, licensing of dealers and extension of rationing. An anti-inflationary programme was announced on the 4th October 1948 with the objective of arresting any further rise in prices and cost of living and securing a progressive reduction in these to reasonable levels. As means to achieve these ends, it laid emphasis on a restriction of the volume of purchasing power available with the people and an increase in supplies. The first was to be attained through balanced budgets, by the cutting down of capital expenditure on schemes not expected to result in an immediate addition to the supply of essential goods, postponement of repayment of Excess Profits Tax and other deposits, raising of the maximum which a person could

<sup>1</sup> See, for example, *Controls—A Study*, Federation of Indian Chambers of Commerce and Industry, 1952; and Ram Gopal Agarwal, *Price Controls in India Since 1947*, 1956.

hold in Post Office Savings Deposits and National Savings Certificates, the issue of Treasury Deposit Receipts, limitation of dividends payable by public companies and tax on luxuries. Increase in supplies was to be brought about by stimulating internal production and by allowing a large flow of imports. To encourage industrial production, various concessions were granted to industries, which included liberalization of depreciation allowances, exemption from taxation of new industrial undertakings of certain categories for a specified period, reduction in import duties on plant and machinery as well as on essential industrial raw materials, reduction or abolition of duties on certain exports and top priority for transport facilities to essential key industries, namely, cement, steel and textiles.<sup>1</sup>

The effect of these measures is reflected in the general price level.

TABLE 72  
MOVEMENT IN PRICE INDICES, 1947-49

| <i>Commodity groups</i>      | <i>Nov.<br/>'47</i> | <i>March<br/>'48</i> | <i>July<br/>'48</i> | <i>Percent-<br/>age<br/>change<br/>of (3)<br/>against<br/>(1)</i> | <i>March<br/>'49</i> | <i>Percent-<br/>age<br/>variation<br/>of (5)<br/>over<br/>(3)</i> |
|------------------------------|---------------------|----------------------|---------------------|---|----------------------|---|
|                              | (1)                 | (2)                  | (3)                 | (4)   | (5)                  | (6)   |
| I. Food articles             | 294.8               | 347.1                | 390.7               | +32.5   | 376.5                | —3.6  |
| II. Industrial raw materials | 377.9               | 397.7                | 449.9               | +19.1   | 462.8                | +2.9  |
| III. Semi-manufactures       | 252.5               | 285.8                | 338.2               | +33.9   | 322.4                | —4.7  |
| IV. Manufactured articles    | 283.2               | 324.3                | 370.2               | +30.7   | 329.4                | —11.0   |
| V. Miscellaneous             | 460.8               | 448.7                | 537.3               | +16.6   | 515.2                | —4.1  |
| VI. All commodities          | 302.0               | 340.7                | 389.6               | +29.0   | 370.2                | —5.0  |

(Source: *Report on Currency and Finance, 1948-49*, Reserve Bank of India.)

The wholesale price index came down from the peak point of 389.6 in July 1948 to 382.9 in August and to 370.2 in March 1949.

<sup>1</sup> Reserve Bank of India, *Report on Currency and Finance, 1948-49*, p. 67.

The decline was general for all groups of articles excepting industrial raw materials. Textiles in the manufactured articles group and cotton yarn in the semi-manufactured articles group showed a substantial fall. Between July 1948 and March 1949, the first fell by 17.7 per cent and the latter declined by 18.1 per cent. Simultaneously, there was a fall in the cost of living also, the Bombay Cost of Living Index (base August 1939 = 100) receded from 310 in December 1948 to 296 in March 1949. Also, between August 1948 and March 1949, the total money supply with the public showed a net contraction of Rs. 18 crores.

#### *Control Measures in 1949-51*

The year 1949 saw a further strengthening of the control measures. About the middle of 1949 the Essential Supplies (Temporary Powers) Act, 1946, was amended so as to bring within its purview raw cotton (ginned and unginned), cotton seeds, coke and other derivatives of coal. What, however, immediately necessitated tightening up of controls was devaluation of the rupee in September 1949. It was feared that devaluation of the rupee would raise rupee prices of certain exports and would facilitate the acquisition of windfall profits by a section of the business classes. This would have an inflationary impact on domestic price structure. It was therefore necessary to appropriate for the Treasury a part at least of the windfall profits and also to take measures against a further rise in the general price level. Accordingly, an Ordinance was issued on 22nd September 1949 which empowered the government to impose export duties on vegetable oils, oilseeds, vanaspati, shellac, steel and tobacco and to enhance the existing export duties on raw jute and jute manufactures. In pursuance of this measure, an export duty of 8 annas per lb. was imposed on mustard oil and 45 per cent *ad valorem* on all controlled categories of iron and steel except sheets for which the export duty was fixed at 30 per cent *ad valorem*. The export duty on hessian was raised from Rs. 80 per ton to Rs. 350 per ton. Also, forward trading in jute manufactures was prohibited by the Government of West Bengal under the direction of the Government of India.

Under the Eight Point Programme of October 1949, a fairly comprehensive scheme of price control was instituted. Among other things, it aimed at reducing by 10 per cent the general level of retail



prices of essential commodities. It also envisaged measures to reduce expenditure on foreign exchange to a minimum, to prevent speculative price increases, to step up savings in the country and give stimulus to investment so as to increase production. As regards reduction of prices of essential commodities, government made an announcement about reducing prices of foodgrains by 3 to 15 per cent by means of cutting down transport charges and other incidental expenses and by lowering procurement prices. In accordance with the policy of the Government of India, the Provincial Governments also reduced the prices of cereals and millets. In the sphere of manufactured goods and industrial raw materials, maximum prices of cloth, yarn and sugar were lowered, the ex-work fair retention prices of pig iron were reduced by about 7 per cent and the selling prices of almost all categories of iron and steel, steam coal, slack coal and coke were substantially reduced. Stimulus to investment was sought to be given by various tax measures, which included abolition of Business Profits Tax and certain concessions under the income-tax. Measures against speculation included the fixing of ceiling price of jute goods for export, banning of forward trading in cotton seeds, raising of the export duty on raw cotton, imposition of an export duty of 30 per cent *ad valorem* on black pepper and prohibition of "futures" and "options" in certain varieties of unrefined sugar.

Agricultural production in 1950 showed some slight improvement over 1948 and 1949. On the industrial side, the output of finished steel increased from 856 million tons in 1948 to 1,005 million tons in 1950, but the production of cotton yarn, cotton piecegoods and jute manufactures declined. Despite increase in the price of some imported commodities, the value of the imports of principal commodities into India in the calendar year 1950 was Rs. 50,138 lakhs against Rs. 60,763 lakhs in 1949. Nevertheless, devaluation was not followed by any great upsurge in price level. The general index moved up from 389.0 in August 1949 to 393.3 in October, but came down to 381.3 in December and again rose to 392.4 in March 1950. Between August 1949 and March 1950 there was a slight reduction in the price level of food articles and manufactured articles, while industrial raw materials and miscellaneous group registered a rise.

The outbreak of the Korean War in June 1950 put the control measures in India to a severe test. Economic conditions in the

country were not quite conducive to stability. Although industrial production was more or less maintained around the 1949 level and production of raw materials such as raw jute and cotton showed an improvement, the output of foodgrains declined sharply. With world-wide rearmament and stockpiling, external demand for some of the export products of the country, like jute goods, cotton textiles, raw cotton and cotton waste and raw wool, increased substantially. This contributed to a favourable balance of payments position. Money supply with the public rose during the year 1950-51 by 99.2 crores as against a decline of Rs. 18.4 crores in the previous year. Scheduled bank credit also expanded against a contraction in 1949-50. There was a rise in the level of business activity also. All these factors helped in pushing up prices. To meet the situation, government announced a fresh Eight Point Programme of controls. In September 1950, the Supply and Prices of Goods Ordinance was promulgated, which provided for the control of the supply, distribution and prices of a further list of articles. In view of the wide disparity between the internal and external prices of certain commodities, fresh export duties were levied or the rates of existing duties were enhanced, as in the case of hessian sacking, raw cotton, cotton waste and raw wool. Also, measures were taken to discourage premium transactions in raw cotton and raw jute and to regulate their supply to mills. However, in view of the prolongation of the war in Korea, rising import prices and heavy export commitments, these measures could not hold the price level. Government therefore had to raise the prices of many articles, like sugarcane, sugar and gur. The pool price of imported foodgrains was raised early in 1951 due to a rise in prices abroad and higher freight charges. Rise in the import prices of raw cotton and the domestic prices of indigenous cotton necessitated an upward revision of cotton textile prices. In the first quarter of 1951, prices of coarse, medium, fine and superfine cloth and raw rubber were raised. The prices of raw jute and jute manufactures also went up. The combined effect of all these was a rise in the general price index from 392.4 in March 1950 to 438.6 in March 1951 with industrial raw materials and the miscellaneous group taking the lead. The first went up from 490.1 to 608.9 and the second from 630.6 to 753.4.

It may be seen from this review that the various control measures adopted by the government between 1939 and 1951 fall into four

main categories: firstly, direct fixing of ceiling prices; secondly, control of speculation; thirdly, absorption of surplus purchasing power; and fourthly, measures to increase domestic supply by encouraging internal production and facilitating larger imports. Although these measures were comprehensive, they were adopted piecemeal as and when required and did not constitute an integrated, well-knit and well-thought out scheme. Nor was any serious attempt made to control incomes and spendings. It is doubtful whether government measures to absorb excess purchasing power through increased taxation and internal borrowing resulted in any marked curtailment of income which would otherwise have been spent. In spite of these failings, it is clear from the account given above that price control in India was on the whole effective in considerably reducing the pace of price rise in certain years and in maintaining stability in other periods.

## CHAPTER XII

### THE EMERGENCE OF A PRICE POLICY

UNTIL the recession of 1951-52 when there was a major downtrend in the price level for the first time since 1940, the problem was one of devising measures which would keep down prices or at least slacken their rate of rise. The rapid decline in prices in that year brought into prominence the need to make price control operate both ways. It was realized that the objective of the government should be not merely the negative one of preventing a rise but a positive one of maintaining general prices at a stable level without any abnormal change in either direction. In other words there should be a price policy in the place of mere price control.

Since 1952 the government has maintained as its objective the stabilization of the general price level and the prevention of undue fluctuations. In the earlier years up to 1955 it was found possible to keep prices from varying greatly from year to year without much strain, but in the subsequent years prices tended to move steadily up and in spite of a consistent effort to control prices especially of foodgrains, the uptrend has continued. The relative ease with which prices were on the whole stabilized in the First Plan period was due mainly to the operation of two opposing forces. In the first place, agricultural and industrial production vastly improved owing to climatic factors and also due to the progress made in the development schemes of the government. The easing of the supply position in the country should naturally have exerted a downward pressure on prices. Secondly, this period witnessed large spendings by the Central and State Governments for development purposes. The execution of the various projects under the First Five Year Plan, involving deficit financing on a substantial scale in the later phases, necessitated an expansion in money supply and bank credit, which in the absence of improvement in the supply of commodities, would have worked as an inflationary force. In actual fact, the operation of these two factors with opposite effects would have helped in a great measure in the maintenance of price stability. This, however, should not lead to any underestimation of the various positive measures taken by the government during this period in that direction. The fact should be stressed that in



consonance with the principles of planned economic development and the building up of a Welfare State, government has had a clear idea of the importance of stability in the economy and has therefore designed its price policy with that definite objective in view.

Recession started about the middle of 1951 and gained momentum as the year progressed; but in the earlier part of the year, prices remained high, reaching the peak point in April 1951. This necessitated the retention and further tightening of some controls and the raising of the controlled prices of many commodities. By instituting quality control and the adoption of a system of licensed trading, control over cotton was strengthened. Three more articles—chrome ore, raw jute and jute manufactures—were brought within the scope of the Supply and Prices of Goods Act, 1950. In order to compensate producers for the rise in production costs and thereby encourage larger production, prices of a wide variety of controlled commodities were enhanced. These included raw rubber, raw cotton, steel, galvanized sheets, wires and tin plates, pig iron, foodgrains, petroleum products and cotton textiles. In the case of the last mentioned commodity, prices were revised each quarter on the basis of the ruling cotton prices in Bombay during a specified period. The 4 per cent cut voluntarily accepted by the textile industry in November 1949 was also restored with effect from April 1951. The "retention" prices paid to the main producers of steel were increased by Rs. 33 per ton for a period of three years effective from July 1951. Also, the issue prices of wheat, rice and petroleum products were raised.

Both domestic and external factors played a part in bringing about the decline in prices in 1951-52; but the deflationary influence of domestic factors should not be exaggerated. The raising of the bank rate from 3 to 3 1/2 per cent in November 1951, and the more stringent policy which the Reserve Bank of India adopted in respect of provision of funds to the scheduled banks marked the end of the cheap money policy. These measures being made to synchronize with the commencement of the busy season had possibly a psychological effect in precipitating a fall in prices. The substantial revenue surplus during 1951-52 together with the sale proceeds of the United States Wheat Loan enabled the government to meet the financial requirements in connection with economic development without drawing from their cash balances. Besides, there was also some improvement in the supply situation. Yet it is worth stressing

that in the downtrend in price level which commenced in the latter part of 1951, external factors, such as modification of the stockpiling programme in the U.S.A. and fall in external demand for many of our export products, played a much more significant part. In the absence of external factors, monetary measures by themselves could not have brought down prices to the same extent as it actually happened.

Steps taken to arrest the downtrend in prices were mainly in the nature of a reversal of the previous anti-inflationary measures. In view of the improved supply position in the country, it was necessary to encourage demand in order to prevent any precipitate fall in prices. Thus, government started removing controls on the production and distribution of a series of articles the supply of which had substantially expanded to justify this change in policy. By the middle of 1952, with larger production and imports, the supply position in respect of foodgrains had very much improved and consequently some of the State governments were allowed to relax controls on foodgrains. These relaxations took the form of reduction in statutory rationing commitments, restoration of free trade within the States, suspension or modification of procurement and liberalization of austerity measures. The system of subsidy on imported foodgrains granted to some of the deficit States was discontinued with certain exceptions after 1st March 1952. By the middle of 1954, the controls in respect of rice were lifted and in March next year restrictions on the zonal movement of wheat were removed, thus eliminating all controls on foodgrains. The control on sugar was gradually relaxed according to conditions of production and supply and towards the close of 1954 government announced that there would not be any statutory control on the price or distribution of sugar, gur and khandsari during the 1954-55 season, but that 25 per cent of the sugar output would continue to be at the disposal of the government. In the latter ~~part~~ of 1952, controls regarding prices, submission of stock returns, etc. over bicycles, bicycle parts and accessories, cycle tyres and tubes and electric bulbs were lifted. Price of vanaspati was decontrolled and all restrictions on production, prices, movement and distribution of oil cakes were removed. In the matter of cotton textiles, fine and superfine cloth were freed from distribution controls and the percentage production of coarse and medium cloth which mills were allowed to sell freely was raised from 50 to 80 in April 1952.

and further to 85 in March 1953. Since the beginning of the last quarter of 1952, price control on most of the popular varieties of cloth was removed, with the result that by the end of March 1953 price controls covered only one-third of cloth production. The usual quarterly remission of cotton textile prices in accordance with the Tariff Board's formula was discontinued. With improvement in output of cotton textiles in 1953 and a slackening of demand, all remaining controls on prices and distribution were abolished in July 1953. The free sale concession granted to mills in regard to the whole of their output of yarn manufactured from foreign cotton was extended since the middle of 1952 to part of the yarn produced out of Indian cotton as well. Relaxation of controls on raw cotton took the form of simplification of the licensing system and the relaxation of the eligibility requirements of the licensees. Forward trading in cotton in Bombay was permitted at the close of 1952 after a lapse of three years. With the abolition of zonal divisions, control over movement of cotton was removed in July 1954. Distribution controls were suspended early in February 1955; only price controls on cotton relating to the fixation of "floors" and "ceilings" were retained. Early in 1953 all varieties of iron and steel pipes and tubes were freed from controls over prices and distribution. The Supply and Prices of Goods Act enacted in 1950 and whose life had been extended subsequently was allowed to lapse with effect from 14th February 1954.

But experience of 1947-48 had shown the government that, while it is easy to remove controls, it is very difficult to reimpose them and bring prices again under control. Hence although since 1952 government adopted a policy of progressive decontrol, care was taken to retain the powers under which control could again be imposed on the economy if conditions demanded it. It was particularly necessary to keep the armoury of controls ready at hand in view of large ~~expendings~~ expenditures by government for development purposes under the Five Year Plans. Thus by an amendment to the Industries (Development and Regulation) Act, 1951, adequate powers were taken by the government to reimpose controls. Again, while in 1952 food control was considerably relaxed, the Union Government in order to prevent prices from getting out of control, as it did in 1947-48, armed themselves with necessary powers under the Foodgrains (Licensing and Procurement) Order, 1952, which prohibited persons from dealings in purchase, sale or storage of any

food grains except under a license issued by the State Government. The Essential Supplies (Temporary Powers) Act, 1946, under which government had derived powers to control essential commodities was, after being extended for a few years, due to expire on 26th January 1955. Hence on 21st January 1955, the President promulgated the Essential Commodities Ordinance, 1955, which was later replaced by a Bill. This Bill as finally passed provided for the control of production, supply and distribution of and trade and commerce in essential commodities as mentioned in the Bill.<sup>1</sup> Control over forward trading in certain commodities which had formerly been exercised under the Essential Supplies (Temporary Powers) Act, 1946, was transferred early in 1955 to the Forward Contracts (Regulation) Act of 1952 which provides for the regulation of forward trading in commodities on an all-India basis and under which the Forward Markets Commission was set up in September 1953.

The policy of progressive decontrol was adopted as a means of counteracting the downtrend in prices resulting from improvement in supply conditions. In addition to this, measures taken by the government in the last few years to maintain price stability were: (a) regulating exports and imports with a view to adjusting supplies to demand; (b) adjusting prices upward or downward in relation to supply and demand conditions; (c) the policy of price support with a view to stabilizing agricultural prices; and (d) recent measures to prevent rise in agricultural prices.

#### (a) *Export and Import Regulation to Maintain Price Level*

The end of the Korean boom showed the extent to which external demand affected domestic prices. With the set-back received by Indian exports, prices of export commodities sharply receded and this reacted on other sectors also. It became therefore necessary to adapt the foreign trade policy of the government to circumstances in the country. Since then, government's policy has alternated be-

<sup>1</sup> These are: (i) cattle fodder including oilcakes and other concentrates, (ii) coal including coke and other derivatives, (iii) component parts and accessories of automobiles, (iv) cotton and woollen textiles, (v) food-stuffs including edible oilseeds and oils, (vi) iron and steel including manufactured products of iron and steel, (vii) paper including newsprint, paper board and straw boards (viii) petroleum and petroleum products, (ix) raw cotton whether ginned or unginned and cotton seed and (x) raw jute. Reserve Bank of India, *Report on Currency and Finance, 1954-55*, p. 35.



tween liberalization and restriction of exports and imports in accordance with the changes in domestic prices and international balances of payments position. For some time, the basic features of government's import policy, namely, strict regulation of imports from the dollar area and fairly liberal imports from non-dollar area remained unchanged. But as regards exports, attempts were made to increase external off-take by reduction of export duties; by liberalizing export quotas and by placing many important commodities like cotton textiles and jute goods on the free licensing list. In the first half of 1953, export duties on cotton cloth, sacking, linseed and linseed oil were reduced, while duties on tobacco seed oil and jute specialities and miscellaneous jute manufactures, other than cloth and bags, were abolished. Indigenous manufactures like electric ceiling fans were allowed to be exported freely. In the case of raw cotton, castor and groundnut oils the existing export quotas were increased. Some commodities temporarily not allowed to be exported were granted export quotas, as in the case of sugar. As an additional encouragement to exports, assistance in the shape of extra allocation for exports was given to steel fabricators who could develop overseas markets and financial help was granted to the Indian Jute Mills Association for a sales promotion campaign for jute goods in the U.S.A. Further, there was also a certain amount of simplification of the licensing procedure. These measures helped in the recovery of external demand for some important commodities, particularly cotton and jute manufactures, and were responsible at least partly to a general rise in commodity prices in the first half of 1953. However, when a bullish trend had manifested itself in the prices of industrial raw materials and export commodities, government reversed its policy. Thus, in order to improve the supply position of essential commodities, government decided about the middle of 1953 to import sugar, liberalized imports of cocoanut oil and copra, reduced import duties on palm oil, copra, sugar and cotton seed oil and placed restrictions on the export of groundnut oil.

Prices once again showed a downward trend in the first quarter of 1954. Since then, with the exception of the third quarter of 1954, prices continued to decline up to the middle of 1955. This was due in the main to slackness of export demand and larger accumulation of stocks as a result of increased internal production. Government's earlier policy of relieving internal shortages of essen-

tial commodities like sugar and cotton by liberalization of imports and the decision to import a substantial quantity of rice from Burma had also a bearish effect. This necessitated the restoration of the policy of liberal exports and the measures adopted earlier in 1953 were repeated. Export outlets were widened by further relaxation of controls. Export duties on a number of commodities, like vegetable oils and oilseeds, black pepper and cotton, were either reduced or abolished. Permission for limited exports was given in the case of rice, pulses, oilcakes, gur and certain wheat products. Free licensing was continued and additional export quotas were granted in the case of a number of commodities like cotton textiles, oil and oilseeds. An Indo-Chinese Trade Agreement was concluded in October, 1954 which provided for the export of tobacco from India. However, the effect on prices of these export liberalization measures seems to have been limited in view of the fact that the policy of liberalization was not confined to exports but extended in some measure to imports as well. Yet, on the whole, during this period government appears to have adapted its foreign trade policy to the economic conditions at home with an eye on its effect on price level. While the fact that these measures to regulate imports and exports did exert an influence on domestic prices cannot be doubted, it may be questioned whether such constant shifts in trade policy did not have a baneful effect on industry and trade in the country.

#### (b) *Direct Price Adjustments*

Side by side with trade and fiscal policies, government also made direct adjustments in the prices of several commodities with reference to their cost of production and demand conditions in the country. In respect of iron and steel and rubber, price increases have been permitted since the middle of 1952 so as to compensate producers for increases in production costs. In June 1952, an increase of Rs. 10 per ton was granted in the statutory selling price of pig iron of all grades to meet the increase in railway freights. It was further raised in November 1953 in order to enable the sale of the costlier pig iron produced by the Mysore Iron and Steel Works at the same price as the pig iron produced by the other two major companies. The selling prices of steel were increased twice during the year 1952 to reduce the additional strain on the Equalization Fund

arising from the increases in retention prices as well as from higher prices of imported steel. The maximum price of Group I raw rubber which was raised from Rs. 128 to Rs. 138 per 100 lbs. in 1952 was further increased by Rs. 12 to Rs. 150 three years later and to Rs. 155-12 recently with suitable differentials for other grades. Further upward price adjustments in respect of coal and steel were made in 1955. On the other hand, as occasion required, some prices were lowered. Thus, towards the close of 1952, the ex-factory prices of the 1951-52 stocks of sugar were reduced from Rs. 30-8/34-14 to a uniform rate of Rs. 27 per maund in the case of North Indian factories and from Rs. 29-12/33-0 to Rs. 28 per maund in the case of South Indian factories. The prices of imported milo and wheat were progressively reduced in 1952 and 1953 and that of imported wheat and rice further reduced in 1954-55. The floor price of cotton, which had been raised for the 1952-53 season, was lowered by Rs. 55 to Rs. 495 per candy for the 1954-55 season. Later, provisions were made for linking the price of sugarcane to the price of sugar by a formula, according to which cane growers should receive the same proportion of the net price realized for sugar that the cost of cane bore to the cost of production of sugar in the different regions.

These various price changes brought about by executive fiat helped to impart an element of flexibility to the controlled part of price structure which otherwise would have deviated much from what conditions of demand and supply would warrant, and for that reason would have become difficult to maintain. Besides, by making such upward and downward readjustments, consumers were enabled to benefit from lower costs of production and increased supplies, and producers were guarded against losses on account of increased costs of production.

### (c) *Price Support*

An important recent development in the matter of stabilization of prices has been the provisions made by government to support agricultural prices. The need for showing special consideration to agriculture in this respect arises essentially from its peculiar characteristics. The responsiveness of agricultural output to price variations is limited. This applies not only to backward countries where agriculture is a way of life but also to advanced countries

where commercialization of agriculture has been carried to a much greater extent.<sup>1</sup> The relative stability of agricultural output combined with fluctuating prices has produced an income for farmers which has been more unstable than the income produced by the relatively stable prices and fluctuating output of the remainder of the economy.<sup>2</sup> A consequence of this feature is that an increase in the demand for farm products causes a greater rise in agricultural prices than in agricultural production. Hence, farmers benefit during inflation. On the other hand, in deflation the prices received by farmers fall farther than other prices. This is due to the fact that the elasticity of agricultural supply, which is normally small, is probably even smaller when prices decline than when prices rise.<sup>3</sup> This is particularly so in a country where small farming is the rule. In an under-developed economy, where agriculture accounts for a large portion of the national income, there are certain additional factors which further aggravate the problem. Firstly, while seasonal and cyclical fluctuations in agricultural prices and income are common both to advanced and less developed economies, in the latter there is the additional difficulty of regional fluctuations. This difficulty arises from the fact that conditions of transport are far from satisfactory in these countries and if such countries happen to be geographically extensive as India is, with considerable regional variations in soil and climatic conditions, the problem becomes all the more serious. A second source of instability in under-developed countries is that in these countries a general expansion in agricultural production, brought about by rapid economic development, might not be immediately followed by a corresponding increase in demand, with the result that prices tend to sag, discouraging production.

There are two main reasons why in the matter of a general price policy, agricultural prices should have priority in India. Since India is primarily an agricultural country, the prices of agricultural commodities enter predominantly into the price index. ~~Even~~ among agricultural commodities, food crops account for 80 per cent of the area under cultivation. The stability of food prices is therefore of fundamental importance to general price and economic stability.

<sup>1</sup> See, for example, League of Nations, *Economic Stability in the Post-War World*, pp. 76, 85.

<sup>2</sup> B. D. Giles, "Agriculture and the Price Mechanism", in *Oxford Studies in Price Mechanism*, eds. Wilson and Andrews, 1951, pp. 173-203

<sup>3</sup> Geoffrey S. Shepherd, *Agricultural Price Analysis*, Third Edition, 1950, p. 16.



Among the food crops, the prices of wheat and rice primarily determine the stability of price over the entire range of agricultural commodities. This underlines the need to hold within predetermined limits the prices of these two food crops even if others could not be regulated. About 60 per cent of the people get their incomes from agriculture and these will be interested in high agricultural prices. On the other hand, the non-cultivator class who constitute at least 40 per cent of the population and who comprise industrial and urban sections, the agricultural classes who receive payments in cash and the landless class would benefit by low prices of food materials. The government's agricultural price policy should therefore be one which, while benefiting the agricultural class, should not jeopardize the interests of the non-agricultural classes. The second important factor which necessitates due consideration being given to agricultural prices in India, especially, in the present context, is that investment in the public sector has of late increased considerably and would increase much more in future. The vast majority of the people in the country spend the greater part of their incomes on foodstuffs. If more money is pumped into the market and increased employment is provided, the larger money incomes so generated are bound to exert considerable pressure on the food front. And in so far as food prices form the cornerstone of the price structure of the economy, it is bound to release inflationary trends. While therefore in the interests of the agricultural classes a minimum income is to be guaranteed and safeguards provided against seasonal, regional and cyclical fluctuations in income, it is equally necessary to fix a maximum limit for the level of agricultural prices in the country.

Instability of agricultural prices and the adverse repercussions of such fluctuations on the national economy have engaged the attention of economists all over the world for quite a long time. Before Keynesian proposals for raising effective demand came up, price level of agricultural products was sought to be maintained by restriction of output. In the policy of restricting supplies to the market, the usual methods adopted were production control by means of plantation restrictions and acreage control in the case of agricultural products, marketing control involving export control and the direct withholding of stocks from the market. Brazil's coffee valorizations, sugar control in Cuba, Stevenson's rubber control, etc. adopted in the 1930's are classical examples of restric-

tions of this type. All these measures failed 'because of various reasons.<sup>1</sup> In recent years many countries have put into operation better thought-out and more scientifically designed price policies in the formulation of which such matters as the effect of agricultural fluctuations on national income, on effective demand and on cost price ratios, etc. have been given due consideration. These policies in general aim at maintaining reasonable parity between agricultural prices and the prices of those commodities which the farmers buy so as to ensure stable real income to the agricultural classes; securing greater economic security for the farmers through more stable farm prices; and lastly facilitating adjustments in production in relation to demand. In accordance with these objectives, the U.S.A. has various price support schemes based on loans to farmers, purchase agreements and also actual purchases through the Commodity Credit Corporation. In the U.S.A. the specific objective of price policy has not been overall price parity but price parity for each farm product, i.e. income parity for each producer group, such as wheat, cotton and peanut producers. In the United Kingdom economic security is provided to the farmers through more stable farm prices by the government committing themselves to offer guaranteed prices for a number of commodities like wheat, barley, oats, potatoes, milk, eggs and wool. Production adjustments in relation to demand have been sought to be attained in many countries of Western Europe, the United Kingdom and the U.S.A. by means of announcing guaranteed prices months before the harvesting period so that producers would have time to adjust their production plans in the light of the prices announced. While these measures have worked on the whole satisfactorily, adoption of them *in toto* by countries like India cannot guarantee the same results in so far as there is considerable difference in the nature of the economy, and in production and marketing conditions in the two groups of countries. Thus, in so far as agricultural economy in the United Kingdom is in the main a food business while in India it covers both food and industrial raw materials, a global approach on the U.K. model is not feasible in our country.<sup>2</sup> Any scheme of

<sup>1</sup> See, for example, Jules Backman, "Government Control of Prices" being Chapter XI in *Planned Society Yesterday, Today and Tomorrow*, ed. by Findlay Mackenzie, 1937.

<sup>2</sup> K. S. Sonachalam, *Indian Journal of Agricultural Economics*, Conference Number, 1955.

agricultural price policy in India should necessarily take into account the special features of her economy.

Measures to stabilize agricultural prices and to guarantee stable income for the farmers are of very recent origin in India. As has been already shown, until 1952 the problem that the government had to face was to hold down the general price level and particularly food prices so as to keep down the cost of living. After the recession in 1951-52, prices of food articles and industrial raw materials recovered in the first half of 1953. But since the third quarter of 1953, with increased production and larger supplies in the markets, there was a sharp set back in these prices. The index number of wholesale prices of food articles came down from 407.0 in August 1953 to 343.2 in June 1954 and that of industrial raw materials declined in the same period from 488.7 to 441.0. On the other hand, manufactured articles declined from 370.8 in August 1953 to 363.8 in December 1953, recovered since then and stood at 378.7 in June 1954, registering a slight rise from the position in August 1953. This shows that in this short period the terms of trade appreciably turned against the agriculturists. To the extent that farm produce accounts for nearly Rs. 5,000 crores or one-half of the total income of about Rs. 10,000 crores, fall in agricultural prices should have meant a substantial loss of purchasing power in the rural sector. The Union Government therefore decided to take measures to support agricultural prices.

Direct methods of price regulation are quite effective if they are adopted at the right time. But a price policy of this nature is all the more successful if it is backed by measures to regulate supply and demand in the country. It has been found by experience that the most effective way of controlling the supply and demand for particular commodities is for the State to enter into the market and carry out purchase and sale operations on their own account. If in a country like India the objective is to remove not only seasonal fluctuations but also regional variations, this would involve purchases of major commodities at minimum economic rates in those areas where prices tend to show a steep decline and the releasing of stocks thus built up in those areas where prices rise abnormally. If these operations are to be successfully carried out, maximum and minimum prices for the commodities in question are to be fixed with reference to the general level of prices, price level of competing crops, cost of living and supply and demand conditions, etc.

In order to maintain the real income of the agriculturists stable, it is important to fix these maxima and minima with reference to the costs incurred by the agriculturists, i.e. the prices of commodities purchased by them. To ensure this parity between the relative price levels of agricultural and non-agricultural commodities, it is necessary to fix the maximum and minimum prices with reference to a base period in which this price relationship was normal.<sup>1</sup> Lastly, this operation requires the purchase and maintenance of large buffer stocks. Adequate financial resources are to be found for this purpose; also adequate warehousing facilities are to be provided. The Prices Sub-Committee recommended the maintenance of 1½ million tons of foodgrains as a buffer stock. This, however, appears to be an underestimate. It has recently been estimated that a working capital of Rs. 75 to Rs. 100 crores would be required to maintain a stock of three to four million tons of foodgrains.<sup>2</sup>

Agricultural price support in the form of open market operations was instituted by the Union Government about the middle of 1954. But the measures adopted in this direction were still of an experimental nature. They were not comprehensive and were not based on any detailed and scientific investigation of the particular issues involved in such a policy. The technique of administration should also be considered as unsatisfactory as compared with the systems that have been evolved in countries like the U.S.A. and the United Kingdom. In instituting the policy, the aim of the government was to support prices of foodgrains if they fell below levels which were uneconomic for producers. This minimum was fixed by the Uttar Pradesh, the Punjab and Rajasthan Governments at Rs. 10 per maund for wheat. Towards the close of 1954 the Union Government decided to purchase from the cultivators jowar and maize at Rs. 5-8-0 per maund and bajra at Rs. 6 per maund in specified markets during the current kharif season. Subsequently, agricultural price support was extended in many States. Thus early in 1956, Uttar Pradesh brought gram also within the scope of price support by fixing its floor price at Rs. 6 per maund throughout the

<sup>1</sup> Thus the V. T. Krishnamachari Committee suggested 1924-25 to 1928-29 as the base period to fix parity prices. This would in practice prevent agricultural prices from being lower than what they were in the early post-war years.

<sup>2</sup> Agricultural Price Policy: Gokhale Endowment Lectures of the Madras University, 1955-56, by Dr. R. N. Poduval, reported in the *Hindu*, November 3, 1955.



State. In March 1955 price support to coarse grains, jowar, bajra and maize, was in operation in seven States, namely, Uttar Pradesh, Bombay, Madhya Pradesh, Rajasthan, Madhya Bharat, Vindhya Pradesh and Bhopal. In Madras an *ad hoc* Committee was constituted for keeping a watch over the prices of essential foodgrains like rice, bajra and other commodities and for taking measures promptly to stabilize prices. Looking back, it is obvious that these measures adopted by the Union and State Governments should have been properly co-ordinated and integrated if the scheme were to work efficiently. It appears that attempts made in this respect were responsible only to a very limited extent for the rise in agricultural prices. Although price support measures were put into operation about the middle of 1954, the decline in the prices of food articles and industrial raw materials continued well into 1955. The index number of the wholesale prices of food articles receded further from 343.2 in June 1954 to 297.0 in March 1955 while in the same period industrial raw materials declined from 441.0 to 412.7.

(d) *Recent Measures to Prevent Rise in Agricultural Prices*

Since the middle of 1955 there has been a general uptrend in prices the food articles along with industrial raw materials showing the sharpest rise, 46 per cent and 49 per cent respectively between May 1955 and June 1960. Prices of jowar recorded a very sharp rise of 150 per cent while rice, wheat and gram went up by 54 per cent 52 per cent and 111 per cent. This change in price trend was caused partly by a decline in output in some years of this period and partly by large government outlays and increase in money supply. Price support measures had therefore to be suspended and price policy reversed with a view to arrest the rising trend of prices. While it is true that in an economy not close to full employment, a mild and gradual and unanticipated rise in prices is stimulating to enterprise and production,<sup>1</sup> the fact remains that in the present context in India it is necessary to prevent food prices from getting out of control if the development plans are to be executed successfully. Nor should it be forgotten that the substantial increases in production about the close of the First Plan period which were respon-

<sup>1</sup> George L. Mehren, Discussion of the Paper on "Production and Distribution Problems under Direct Price Controls" by Don Pearlberg, *Journal of Farm Economics*, American Farm Economic Association, 1951, p. 685.

sible in a great measure for the fall in agricultural prices, were largely due to a run of favourable seasons. The fact that such regular occurrence of good years cannot be guaranteed and that the financing of the Second Five Year Plan has resulted in the building up of a large inflationary potential and the possibility of the pressure of excess demand to continue make one feel that the necessity in the next few years would be to adopt measures to keep down agricultural prices rather than to give artificial support so as to prevent them from declining.

Techniques adopted by the government in the last three years or so to restrain the rise in the prices of food articles and other agricultural products aim at maintaining the price level by improving the supply position and distribution and also by controlling demand particularly speculative demand. While attempts at increasing domestic production to the maximum extent possible have been continued without any relaxation, steps also have been taken to import food to augment the supplies available for the consumer. In 1956 an agreement was entered into with the U.S.A. Government under U.S. Public Law 480 for the import of wheat and also with Burma for the import of rice. By another agreement with the U.S.A. in the next year provision was made for importing 8 lakh tons of wheat through diversion of the funds originally intended for imports of cotton, tobacco and dairy products. Further arrangements were made for procuring 38 lakh tons of wheat from the U.S.A. in 1958 under Public Law 480. Besides in March 1959 a barter agreement was made with the U.S.A. involving the exchange of 4.5 lakh tons of surplus U.S. grain for Indian manganese, ferro manganese "and such other materials as may be agreed upon". In addition, two deferred payments agreements were entered into with Canada in 1958 providing for Canadian dollars 33.8 million for the purchase of 5.4 lakh tons of wheat from that country. With a view to obtaining larger quantities of food grains in 1960 a fourth agreement under Public Law 480 was signed with the U.S.A. in November 1959 for the purchase of about 30 lakh tons of wheat and flour as well as other commodities like cotton, tobacco and foodgrains. Also, two more agreements were concluded with Canada for the supply of wheat, and fresh agreements were entered into with the U.S.A., Burma and the United Arab Republic for the importing of rice. The latest agreement in this direction is the one made with the U.S.A. in May 1960, under the Public Law 480 programme for

the import of 16 million metric tons of wheat and 1 million metric tons of rice over a period of four years. Over the four years 1956 to 1959 imports of foodgrains amounted to Rs. 1.2, 35.9, 31.7 and 38.1 lakh tons respectively. Simultaneously the export of industrial materials chiefly raw cotton and food grains has either been restricted or altogether prohibited.

Although in importing food grains the government had the overall requirements of the economy in view, it was soon found necessary that in order to maintain prices at a comparatively stable level, government had to supplement imports by arrangements to ensure proper distribution as between States and between different regions of the country. This was sought to be attained by regulating the distribution of imported food grains at controlled prices by setting up food zones, and by government's procurement of food grains available in the different zones and States and their distribution through agencies under its control. In 1956, about 20,000 fair price shops were opened in many parts of the country for the distribution of imported food grains; and towards the close of 1958, in order to prevent the sale of imported food grains at high prices the Government of India promulgated the Imported Foodgrains (Prohibition of Unauthorized Sale) Order 1958 forbidding the sale or storage of any quantity of imported foodgrains except by authorized dealers. The zonal system aimed at making each zone depend on its own resources as far as possible. About the middle of 1957 three wheat zones were created, the Punjab, Himachal Pradesh and Delhi forming one, the Uttar Pradesh constituting the second, and Rajasthan, Madhya Pradesh and Bombay (excluding Bombay City) the third. Subsequently these were reconstituted into five zones, viz. (1) the State of Punjab and the Union territories of Himachal Pradesh and Delhi (2) Uttar Pradesh (3) Madhya Pradesh (4) Rajasthan and (5) Bombay. Under this zonal arrangement movement of wheat and wheat products within a zone is free, but inter-zonal exports and imports are not permitted except under a permit issued by the State Governments concerned. In July 1957 a rice zone on the model of the wheat zone was formed comprising the southern States of Andhra Pradesh, Kerala, Madras and Mysore with a view to promoting regional self-sufficiency and avoiding cross movements of rice; in September 1958 a second rice zone covering the State of Punjab and the union territories of Himachal Pradesh and Delhi was created; and late in 1959 the Eastern Rice Zone comprising the

surplus State of Orissa and the deficit State of West Bengal was formed. Within each zone provision was made for the purchase of food grains by the Central or State Governments and the release of such purchases through fair price shops. To this end, the Essential Commodities Act 1955 was amended in 1957 empowering the government to requisition stocks from dealers at prices equivalent to the average market price ruling in the preceding three months. The State Governments were given the freedom to fix the purchase and sale price with reference to local conditions of demand and supply. Accordingly in 1958 a number of State Governments resorted to purchase of rice and paddy on their own account. However, in order to check the rise in prices and to facilitate procurement, the Government of India also fixed maximum controlled prices for paddy and rice in almost all the States. Moreover, most of the States have promulgated orders licensing the wholesale dealers and requiring them to maintain daily accounts of their transactions and to file periodical returns regarding stocks, purchases and sales of individual food grains.

One important step taken towards regularizing distribution as a long term policy was the introduction of state trading in food grains in April 1959. The main objective of the scheme is to reduce to a minimum the spread between the prices paid by the consumer and received by the producer and at the same time ensure a fair price to both parties. To begin with, it is the aim of the government to confine state trading operations to wheat and rice and to conduct it on a no-profit-no-loss basis. In order to ensure a minimum price for the producer, government agencies would be set up to purchase food grains from the producers at controlled prices which are to be uniform for a whole State or region. Although retail prices are not to be controlled in the earlier stages, the ultimate aim of state trading is to influence retail prices by increasing the number of fair price shops and by channelling retail trade through consumers' co-operatives. At the other end, collection of farm surpluses is to be done by service co-operatives in the villages. The first State to introduce state trading was Orissa where under the Orissa Foodgrains Control Order, which came into force on the 1st of January 1959 the State took powers to procure all surplus stocks of paddy and rice through authorized dealers who were bound by agreement to buy from producers at minimum prices fixed by the State and sell to the government at prescribed rates. However, state trading in



foodgrains has not been successful. In fact in 1959, two State Governments; West Bengal and Bihar gave up procurement of rice while Madras and Mysore decided not to undertake procurement operations in the 1959-60 crop. Thus in 1959-60 procurement of rice continued in six states only, viz. the Punjab, Madhya Pradesh, Andhra Pradesh, Uttar Pradesh, Assam and Orissa.

Most of the measures adopted by the Central and State Governments in the matter of regulating prices of foodgrains through arrangements for better distribution coincided with the recommendations of the committee set up by the Union Government in 1957 to investigate the causes of rising food prices. In the Report which the Committee submitted about the end of 1957 it made some additional recommendations such as the formation of a Price Stabilization Board, the establishment of a Foodgrains Stabilization Organization for undertaking open market purchase and sale of foodgrains, formation of a non-official Central Food Advisory Council and creation of a Price Intelligence Division.

In addition to the provision for increased imports and better distribution of available resources attempts have been also made to curb demand particularly of the speculative kind through monetary and credit control measures and also through the agency of the Forward Markets Commission. To restrain credit expansion in general, all the usual techniques such as bank rate, moral suasion and selective credit control have been tried. On the 1st March 1956 the Reserve Bank raised its lending rate under the Bill Market Scheme from 3 per cent to  $3\frac{1}{4}$  per cent (i.e.  $\frac{1}{4}$  per cent below the bank rate) and later to  $3\frac{1}{2}$  per cent effective from 21st November 1956. In the next year the Stamp Duty on usance bills was raised so that the effective borrowing rate of scheduled banks against usance bills was further increased by  $\frac{1}{2}$  per cent. Simultaneously the bank's lending rate on advances against government securities was increased from  $3\frac{1}{2}$  per cent to 4 per cent. With effect from 16th May 1957 the bank rate itself was raised to 4 per cent, but the Stamp Duty on usance bills was reduced to one fifth of 1 per cent so that the effective borrowing rate of scheduled banks against usance bills came to be lowered to  $4\frac{1}{5}$  per cent. Recently with a view to control the boom on the stock exchanges and to restrain the volume of bank credit against equity shares, a minimum margin requirement of 50 per cent was imposed in respect of advances by scheduled banks against equity shares. Besides, the Reserve Bank invoked for the first time on 11th March

1960 its powers to vary the reserve ratios by requiring the scheduled banks to maintain with the Reserve Bank additional balances equivalent to 25 per cent of the increase in their total deposit liabilities since that date. Subsequently, these reserve requirements were raised to 50 per cent of the increase in demand and time liabilities with effect from 6th May 1960. Apart from these, the Governor of the Reserve Bank, by means of letters and directives to the banks, has reiterated the need for refraining from excessive expansion of credit.

The latest move in this direction is the announcement by the Reserve Bank of India on 21st September 1960, of three monetary measures to hold the price line. These are: (1) Penal rates of interest for borrowings from the Reserve Bank by banks in excess of the quota fixed for each. The quota allotted to each scheduled bank is 50 per cent of the reserves required to be maintained by it with the Reserve Bank. The bank rate is charged on scheduled banks' borrowings up to this limit; if such borrowings exceed 100 per cent but are less than 200 per cent of the quota the rate of interest payable to the Reserve Bank is to be 1 per cent above the bank rate; the rate rises to 2 per cent over the bank rate on borrowings above 200 per cent of the quota. (2) An increase in the average lending rate by banks to their customers by half a per cent. The scheduled banks are required to adhere to a minimum lending rate of 5 per cent on all advances with the exception of advances to other banks including Co-operative Banks. Where the minimum lending rates of banks are 5 per cent or more, the banks are to raise the rates further so as to ensure an increase in their average lending rate by at least half-a-per-cent. (3) Limit on the interest rate paid by banks on short term deposits. No scheduled bank shall pay interest at more than 2 per cent below bank rate on any deposit (other than inter-bank deposit) repayable on notice or on the expiry of a period not exceeding 21 days from the date of deposit.<sup>1</sup> These measures came into operation on the 1st October 1960. The main objective behind these measures is to keep down rise in prices to the extent such a rise is caused by undue expansion of credit and borrowings of scheduled banks from the central bank. That there is sufficient reason for the adoption of such a stringent attitude on the part of the Reserve Bank is indicated by the fact that on 9th September 1960, the borrowings of the banking system from the central

<sup>1</sup> The *Hindu*, dated 23rd and 24th September 1960.

bank stood at Rs. 52.04 crores against Rs. 1.78 crores in the corresponding period of the previous year. Total advances of scheduled banks have also remained well above Rs. 1,000 crores. Virtually, these three-fold measures would have a more direct impact on the credit policy of the banking system and on speculative activity than the traditional technique of raising the bank rate. Since the total of demand and the time liabilities of the scheduled banks amount to about Rs. 2,000 crores, the reserves they are to keep with the Reserve Bank in terms of Section 42, Sub-section (1) of the Reserve Bank of India Act would be about Rs. 60 crores. The quota of borrowings permitted to the banking system in general on which the bank rate will be charged will therefore be half of this sum or Rs. 30 crores. Penal rates of interest are payable on borrowings above this limit. As regards rates of interest to be charged by banks to their clients, the prevailing rates range between  $6\frac{1}{2}$  and  $7\frac{1}{2}$  per cent and these rates will be increased by half-a-per-cent at the direction of the Reserve Bank.

To what extent these monetary measures would be really effective in holding the price line is difficult to say at this stage. They would doubtless have a restraining effect on the speculative boom in share prices. In fact the immediate reaction was a marking down of prices in the stock markets. Credit squeeze is likely also to bring about a fall in the prices of some commodities especially in respect of those, the dealings in which come within the purview of the organized sector of the money market in the country. Recently, the Governor of the Reserve Bank pointed out that the organized sector of the money market is growing and is doing about 50 per cent of the financing of industry and trade.<sup>1</sup> On the other hand, it is feared that the industries and export trade will be hit hard and other agencies might step in for purposes of financing industry and trade. It has to be stressed that these measures operate only on the demand side and even that in a restricted sphere. Any adverse reaction on the side of production and supply would therefore, to say the least, only help in the continuance of the gap between the availability of the resources and the demand for them by keeping down both, and would thus neutralize the effect of credit restraint on the price line.

<sup>1</sup> Reserve Bank Governor's speech at the Thirty-third Annual General Meeting of the Indian Institute of Bankers (18th August 1960), *Indian Finance*, Calcutta, dated 27th August 1960.

The general measures of credit control such as the bank rate and the use of moral suasion have primarily aimed at bringing about an overall quantitative reduction of credit. Along with these, use has been made of the methods of selective control of credit with a view to curbing the speculative rise in the prices of food articles and certain industrial raw materials. The main idea behind selective credit control measures is to moderate fluctuations in prices resulting from seasonal changes in the supply and movement of essential commodities. In executing this policy two methods have been adopted—fixing the margin in respect of advances against agricultural products and secondly limiting the over all advances for any particular period or season with reference to the maximum of a previous period. In the earlier part of 1956 it was observed that credit extended by banks against certain commodities, especially foodgrains and cotton textiles, including yarn, was unduly large. There were, besides indications that in some centres bank accommodation was being partly utilized for speculative hoarding of paddy and rice. To counteract this tendency a directive was issued by the Reserve Bank on 17th May 1956 which required the banks to refrain from excessive lending against commodities in general, to raise the margins in respect of loans against paddy and rice by 10 per cent and to limit fresh advances or credit limits against these two commodities to a maximum of Rs. 50,000. They were also requested to endeavour to bring down advances against paddy and rice to a level not more than 125 per cent of that in the corresponding period of the previous year. Subsequently at every upward turn in the expansion of credit these measures have been further tightened. Thus about the middle of 1957 the margin requirements were raised to 40 per cent in respect of foodgrains and the banks were required to maintain the level of credit at not more than 66½ per cent of the level obtaining in a corresponding period in the previous year against paddy and rice and 75 per cent in respect of other foodgrains. It was also desired that banks should not sanction any fresh credit in excess of Rs. 50,000 against foodgrains or increase the existing credit limits against such securities, if such securities were below Rs. 50,000 in value. With effect from the beginning of 1958 the upper limit of credit against paddy and rice and wheat and other foodgrains was raised to 75 per cent and 80 per cent respectively of the average of similar advances during the corresponding months of 1955, 1956 and 1957. Further,



as experience in the earlier period had shown that there was a tendency among banks to concentrate their overall permissible advances against foodgrains in surplus States only, defeating thereby the main objectives of control, the banks in the States of Andhra Pradesh and Madhya Pradesh were required to maintain in each month a level of advances against specified foodgrains not exceeding 60 per cent of the advances in the corresponding months of 1957. With a further rise in the price of wheat, paddy and rice and in bank advances in the States of Punjab, Madhya Pradesh and Andhra Pradesh similar credit control measures have been further tightened up in these states particularly since the close of 1958.

Selective Credit Control methods have been extended to other commodities as well, such as cotton textiles, oilseeds and sugar. To counteract the contra seasonal rise in the price of sugar a circular was issued in June 1957 requiring banks to raise margins against sugar advances by 10 per cent subject to a minimum margin of 35 per cent and to bring down advances against this commodity to a level not more than 10 per cent above that in the previous year. This minimum was raised to 45 per cent in 1958 in respect of sugar stocks which had been lifted from the factory premises and on which excise duty had been paid; other advances to factories were, however, kept free from the margin provision so that manufacturing activity in respect of sugar may not be effected. Besides foodgrains and sugar, advances against oilseeds like groundnut were also subjected to control early in 1959.

Another means to control the speculative bidding up of industrial raw materials which has been tried in recent years is the imposition of restrictions on future contracts through the agency of the Forward Markets Commission. With effect from 11th February 1957 the East India Cotton Association with the approval of the Forward Markets Commission imposed stringent margins on future contracts in cotton. Two months later, the Forward Market Commission raised further the rates of margin deposits. About the end of 1959, the Forward Markets Commission raised the margin payable on cotton future contracts from Rs. 25 to Rs. 75 per bale if the price rose above Rs. 770 per candy.<sup>1</sup> The margin payable when prices rose above Rs. 750 was also stepped up from Rs. 15 to Rs. 25. In order to prevent excess stocking by mills, the Textile Commissioner issued an order in December 1959 for-

<sup>1</sup> One Candy = 500 lbs.

bidding mills from buying or possessing stocks of cotton in excess of three months' consumption. Also, a quota system was introduced under which mills were not allowed to buy more than an initial 50 per cent of their consumption of Indian cotton during the 1958-59 season with a maximum limit of 60 per cent for mills situated in certain areas. In the case of groundnuts and castor seeds a stiffer margin of Rs. 15 per candy against the earlier margin of Re. 1-Rs. 4 was enforced in February 1957 on the net outstanding position of forward purchases if the ruling price was above Rs. 165 per candy. About the middle of 1957 the higher rate of margin deposits was removed but at the close of the year a special margin of Rs. 25 per candy was imposed in respect of groundnut futures contract on the Bombay Oils and Oilseed. Exchange and other recognized Associations on all net purchases at prices above certain levels. The Government of India banned forward contracts as well as non-transferable specific delivery contracts for the purchase or sale of certain coarse grains and pulses in July 1958; this ban was extended to rice and paddy on March 2, 1959. In respect of oilseeds the margins on future contracts were further raised by the Forward Markets Commission in April 1959 to Rs. 15, Rs. 25, Rs. 45, and Rs. 65 respectively on contracts above Rs. 165, Rs. 175, Rs. 185.50 and Rs. 198 per candy. Early in 1960 a special margin of Rs. 106.25 per candy was imposed on groundnut contracts if the price rose above Rs. 212.50 and ceiling prices were fixed for groundnuts and groundnut oil. The margin system was also extended for the first time to hedge and transferable specific delivery contracts in groundnut oil. Similar action was taken in respect of castor seed and linseed, raw jute and jute goods contracts as well.

Although selective credit control methods have been made full use of since 1956 and have been applied with a certain degree of consistency, their effect on the level of prices has been quite meagre. The tightening of these measures in periods of undue expansion of credit has on occasions been attended with a rather immediate and perceptible response in prices but the results have not been lasting. Thus in 1958-59 while price of rice was maintained at the previous year's level that of wheat and other foodgrains recorded a steep rise; prices of oilseeds, particularly groundnut also spurted up. It is also worth pointing out that even the small effect that selective control measures had on price level a year or two ago is not observ-

able in recent months. In May 1960, the Governor of the Reserve Bank required the scheduled banks to bring down the level of advances by about Rs. 110 crores in the current slack season (May to November), but it has been reported that in the first half of this period the contraction did not amount to even one tenth of this sum. Besides, the level of advances in recent months against paddy and rice, wheat, sugar and gur and groundnuts and other seeds except in the case of the last was actually higher in 1960 than in the previous year. In the middle of July while the advances against oilseeds stood at about Rs. 20 crores as against Rs. 31 crores in 1959 those against sugar and gur rose to Rs. 65 crores or Rs. 25 crores in excess of the previous year's level. Advances against rice and wheat were also slightly higher. In this connection, the explanation given by the Reserve Bank of India that the distinction between the traditional busy and slack seasons has been wearing thin with the industrialization of the economy and its progressive expansion is not quite convincing.<sup>1</sup> Indications of a temporary response in price to controls of this nature have been more due to psychological factors than to any basic changes in the situation. In reality it is idle to expect any lasting or substantial effect in this matter in view of the fact that selective credit control measures constitute a monetary tool operated by the central monetary authority of the country and as such has only a restricted scope in a country with a wide unmonetized sector and in which credit money forms only a very much smaller proportion of money supply than in economically advanced countries. Furthermore, the general price level of a country depends on various factors operating on supply and demand over which selective credit control methods can have no influence. These measures can have a bearing only on a limited sphere namely, their impact on the pressure of demand originating from bank credit. At best then, the conclusion regarding the successfulness or otherwise of this technique of price control has to be made in a negative manner by saying that but for the exercise of these methods the uptrend in prices would probably have been sharper.

This, however, is saying little on behalf of the methods which have been tried in recent years. In fact, the limited effectiveness of these measures raises the major question whether the free forces of supply and demand would not have taken better care

<sup>1</sup> The *Hindu*, dated 8th September 1960.

of the situation. Controls, whether they are physical or monetary are the opposite of competition. In theory competition would ensure the flow of commodities from regions where they are relatively abundant and where their prices are low to other areas where they are scarce and prices high with the result that price fluctuations will be moderated. Speculative building up of stocks is after all for the purpose of selling and making profits thereby, and as such higher prices and scarcity in particular regions would by themselves attract supplies and ease the pressure of demand. All this sounds logical and convincing, but in the present context in India free competition is not likely to work efficiently for the following reasons.

In the first place, there is an overall deficiency in the supply of foodgrains. Since production is not sufficient enough to meet the requirements of a rapidly increasing population, even if we assume that competitive forces would bring about an equitable distribution as between different regions of this sub-continent, the basic shortage remains and to that extent when money incomes rise in the context of a high degree of income elasticity of demand for food, prices are bound to soar up. In actual fact, however, the sort of distribution that is possible under ideal competitive conditions is not possible in India because of the vastness of the country and the lack of adequate transport facilities and because of the fact that agriculture has not been commercialized in this country to the extent it has been done in some of the high income agricultural countries. And the second factor is that in the presence of the above mentioned difficulties speculative hoarding not only becomes common, but takes on an aspect which is different from what it would be under other conditions. While speculation as an effective means of moderating fluctuations in an organized, developed and competitive economy is conceivable, it invariably produces only bad results in an economy like ours. Mostly, speculators build up stocks in urban areas with a view to make large profits not so much by moving the goods to distant scarcity areas as by retaining them and selling them in the areas where they are accumulated at high prices. Such an unsocial activity pushes up price to a higher level than supply and demand conditions would warrant and takes it beyond the reach of the low income earners and the poor. Social justice therefore calls for the control of such activities and the ensuring of fair distribution through alternative means.

In a growing economy the level of investment is bound to increase



steadily. In India it is certain that investment in capital intensive projects would rise at a faster rate than other investments over a long period of time. Demand for foodgrains and other necessary consumption goods would increase steadily not only because of the rapidly growing population but also because of the fact that a vast proportion of the population is living below the poverty line and as such with every increase in money incomes the demand for such goods would increase at a higher rate. In other words, the problem of scarcity of food will be with us for long unless a much larger annual increase in food production than has so far been possible is achieved. And this would necessitate the refining and remodelling of our techniques of control so as to make them effective enough against the special problems that may arise in our economy. While the control techniques that have evolved in recent years have been well conceived, they have certain basic defects in their formulation as well as in their execution which account for their limited success. Recent credit control measures especially of the selective type touch only the fringe of the problem and do not go to the roots of it. They are directed against only one of the several factors responsible for rise in prices. But such nibbling at the problem does greater harm than would result in the absence of it. It produces a bad psychological reaction. The application of any method of control is considered as an indication of future shortage or scarcity, so that when it is not adopted in a thorough and comprehensive manner it would by itself promote the very unsocial activities which such measures are ostensibly designed to obviate. It is also an open question whether the knowledge relating to yield, supply and requirements of particular regions in the country is adequate enough to successfully implement any scheme of fair distribution. We hear quite often criticisms about the lack of co-ordination between the states among themselves, between the States and the Centre and between the agricultural department and other departments at the Central and State levels. A clearer understanding of the size and nature of the problem and a proper assessment of the situation is a *sine qua non* for the success of any scheme to keep down prices. Lastly, it may be mentioned that the success of controls depends in a great measure on the efficiency of the administrative system behind it. Well-laid schemes of distribution and control go to pieces in the absence of vigilance and alertness and a sense of fairness and equity on the part of the administrators.

*The Future of Controls*

It remains to consider the broader question as to how far controls are necessary in a country which is in the earlier stages of planned expansion. Many of the controls which had been instituted during the war or early post-war years have been removed gradually on the ground that the conditions which necessitated them no longer exist. But even the remnants of control that remain have come in for a good deal of criticism. It has been pointed out that to the extent that our economy is not so compact and organized as that of other countries, price controls cannot operate efficiently. In India controls have been clamped on the economy as and when particular requirements arose without any thorough investigation into their rationale. It has been argued by the business section of the community that controls have clogged the wheels of production, have thrown additional burdens on the administration and have involved huge cost to the government.<sup>1</sup> Apart from these, some defects common to price controls in general have been pointed out. Whatever be the care taken to make the controlled price as near to market price as possible, the former still is fixed in an arbitrary way and has therefore an element of artificiality in it. The guaranteeing of a fixed price quite often leads to wasteful use of materials and resources. The more comprehensive and strict the system of controls, the more do cost-price relations become rigid. This rigidity is inimical to economic progress. Quite often it leads to speculation in inventories and to black marketing. Further, when once they are adopted there is a tendency for controls to be extended. Thus control of necessities alone leads to the increased production of luxuries, which unbalances the economy. To set it right, luxury articles have also to be brought within the scope of controls so that there is no end to the interference in private life.<sup>2</sup> The transfer of real wealth from one section of the people to another brought about by a system of controls is sometimes disadvantageous to the community. Price control by adversely affecting production incentives helps to lower national income. These, along with other defects, real and imaginary, are mentioned by the advocates of free prices to build up a case for the removal of all types of economic controls.

<sup>1</sup> Federation of Indian Chambers of Commerce and Industry, *Controls—a Study*, 1952, pp. 96-7.

<sup>2</sup> F. R. J. Jervis, *Price Control*, 1949, pp. 208-9.

But, the case for or against price control depends on whether conditions justifying it exist or not. The free price mechanism is only a fair weather system and can function properly only in normal times. The forces of the price system cannot by themselves accomplish large readjustments in the economy.<sup>1</sup> Hence when there are serious maladjustments in the economic system, as for example, when heavy government expenditure in war or peace time leads to inflationary trends or when difficulties arise in the balance of international payments, controls become necessary. It is, however, important to observe the difference between the economic effects of abnormal expenditure of government during war time and similar expenditure for developmental purposes in peace time. In war time, unlike as in normal conditions, controls have necessarily to be adopted in haste. Large-scale expenditure by government when the country is engaged in war is a temporary phenomenon, but if the government is spending large amounts in a programme of economic development it tends to be continuous. Investments in war period are made for a destructive purpose, while in peace time they result in tangible assets which facilitate increased production. The inflationary potentiality of war expenditure is therefore larger than that of development expenditure in peace time. On the other hand, the operation of economic controls in normal times tends to be difficult because of the absence of economic patriotism and of any sense of urgency.

The future of controls in India is linked up with planned economic development. Price control is necessary in so far as economic development implies the stepping up of the scale of investment in the economy. Investments in the public and private sectors involve huge expenditure which do not add to the volume of supplies immediately or even in the short period. To the extent that such capital outlays outstrip current savings out of incomes, they generate additional incomes the spending of which draws upon existing stocks and creates inflationary pressure in the economy.<sup>2</sup> If this trend is left uncontrolled, it promotes the inflationary cost price spiral which as it gathers momentum would dislocate the national economy, hamper fresh investment and production and defeat the very purpose of planned economic development. It is true that

<sup>1</sup> H. D. Henderson, *The Inter-War Years and Other Papers*, ed. by Henry Clay, 1955, p. 419.

<sup>2</sup> R. G. Hawtrey, *Economic Rebirth*, 1946, p. 135.

an inflationary pressure of this nature stemming from maladjustments in supply and demand cannot be stopped merely by price controls. Measures to curtail demand or increase production and supplies in relation to demand can alone go to the root of the problem. Nevertheless, a comprehensive anti-inflationary policy including such measures should begin with a system of direct price controls, because price control establishes the base and gains the time necessary to wheel into position the more durable machinery of systematic allocation and rationing and fiscal measures that do stop inflation.<sup>1</sup>

There is another reason why price control or something more than price control is necessary in the context of economic development. The essence of planned development is allocation of available resources among different lines of investment both in the public and in the private sector according to an overall pattern. Such an allocation is designed with a view to evolving an economic order different from what it would be in the absence of planning. Allocation of this nature and investments of the necessary magnitude in required lines cannot be accomplished under a system of free prices. It is therefore important to maintain price controls as well as physical controls. In fact the more comprehensive the system of controls and the greater is the degree of strictness with which they are administered, the easier and the more successful becomes planned economic development. Economic regimentation, however, would not be possible in a country which believes in the principles of democratic government. But, as Professor Meade has shown, "Between regimented planning and perfect freeplay of prices a *via media* is possible. This makes full use of the money and price systems but controls that system in such a way that prevents inflation; that brings about better distribution of wealth and income and that controls the emergence of monopolistic organization".<sup>2</sup>

The fact that in the matter of finding resources for development considerable reliance has been placed on deficit financing further strengthens the case for controls in India. In the last nine years of planned development deficit financing amounted to about Rs. 1,450 crores. This makes 27 per cent of the total outlay on the Plans and works out to over Rs. 160 crores on the average per year. The

<sup>1</sup> J. K. Galbraith, "Price Control" in *The American Economic Review* (Supplement), March 1943, pp. 258-9.

<sup>2</sup> J. E. Meade, *Planning and the Price Mechanism*, 1948, p. 11.



inflationary potential of financing of this nature has been indicated earlier.<sup>1</sup> While the rise in prices normally arising from financing of this kind on a large scale may be deemed useful in so far as it helps in the transfer of real resources to the public sector, it is of the greatest importance to take sufficient precautionary measures to guard against the danger of such a price rise getting out of hand and developing into run away inflation. The need for increasing tax revenues was duly stressed by the Taxation Enquiry Commission,<sup>2</sup> and the Planning Commission have also realized that in a developing economy current revenues should make an appreciable contribution to the financing of projects on capital account.<sup>3</sup> The shift in the emphasis on the different means of financing envisaged in the draft outline of the Third Five Year Plan is in recognition of this imperative need to rely more on non-inflationary resources. It is indicated in this *Outline* that deficit financing in the five years 1961-62 to 1965-66 should be kept down to Rs. 550 crores or less than 8 per cent of the total outlay of Rs. 7,250 crores in the public sector, while current revenues and resources from loans and savings are to be raised to Rs. 4,500 crores or to 62 per cent. Secondly, steps should be taken to maintain an adequate reserve of foreign balance so as to finance an import surplus when necessity arises to strengthen domestic supply position and counteract any abnormal rising trend in prices. To achieve this end, control of foreign exchange and trade is to be continued. Lastly, for reasons given earlier, prices of agricultural products and industrial raw materials are to be controlled and regulated in such manner as to narrow down as far as possible the limits of their fluctuation. This would necessitate, apart from the fixing of maximum and minimum prices, control of supplies so as to facilitate the working of price controls. There is no reason why the same method cannot be extended to finished industrial products also. In fact, the control of the prices of raw materials and agricultural products makes it easier to control the prices of manufactured products as well. The argument usually raised against these measures, namely, that they would hamper production is not convincing. Experience of the working of similar controls in the war years in the U.S.A. has shown that production did not fall because of controls; nor did price control

<sup>1</sup> See Chapters VI and VII.

<sup>2</sup> *Report of the Taxation Enquiry Commission* (1955), Vol. I, pp. 96-7.

<sup>3</sup> Government of India, Planning Commission, *Second Five Year Plan*, p. 82.

limit businessmen's action.<sup>1</sup> Thus, the fear of the businessmen that initiative would be lost in a system of controls appears largely unfounded. Price control does not affect business incentive when effective demand is high as in war time. Therefore, in peace time also, if effective demand goes up because of large investment outlays, rise in the levels of employment and monetization of large segments of the agricultural sector, there is no justification for any fear about fall in business incentives because of price control measures. But in order to ensure the satisfactory operation of these measures what is most needed is to tone up the administrative mechanism, root out corruption and make it a really competent body infused with a genuine zeal for safeguarding public interests. It is important that government maintains a close watch over investment in the private sector, the wage level in the key industries and trends in foreign trade. These are not so much controls as regulatory measures, measures inevitable and necessary in a country which has as its ideal the building up of a welfare state based on social and economic justice and which believes in planned economic development as the surest means of achieving that ideal.

<sup>1</sup> George Katona, *Price Control and Business*, 1945, pp. 206-7.

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